KENYA REVENUE AUTHORITY

# CIAT Technical Conference

# Prevention and control of tax evasion

INTER-AMERICAN CENTER OF TAX ADMINISTRATIONS
CIAT
• ESTABLISHED IN 1967 •

CIAT
Technical Conference, Nairobi 2013

Nairobi, Kenya
September 9-12, 2013

Inter-American Center of Tax Administrations - CIAT
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# CIAT TECHNICAL CONFERENCE

Technical Conference, Nairobi 2013

## PREVENTION AND CONTROL OF TAX EVASION

**September 9-12, 2013**
**Nairobi, Kenya**

P.O. Box 0834-02129
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Web site: http://www.ciat.org
E - mail: ciat@ciat.org

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# ABOUT CIAT

## ABOUT CIAT

CIAT is a public, nonprofit international organization established in 1967, with the mission of providing an integral service for the modernization, strengthening and technical development of the Tax Administrations of its member countries. Its membership currently consists of 38 member and associate member countries from four continents: 31 countries from the Americas, five from Europe, and one from Africa and one from Asia. India is associate member countries.

The Web site: www.ciat.org includes information of a technical and institutional nature, as well as on the various activities carried out such as international meetings, tax studies, publications, training, technical assistance and information technology.

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# TOPIC 1

# TAX AUDITS IN THE DIGITAL AGE

*Lecture*

*Topic 1*

# TAX AUDIT IN THE DIGITAL AGE

**Jaco Tempel**
Deputy Director Fiscal Affairs
Netherlands Tax and Customs Administration
(The Netherlands)



*Presentation PPT*

## TAX AUDIT IN THE DIGITAL AGE

The digital age and the development in Information and Communication Technology affect all areas of the work of tax administrations. ICT-developments have major impact on the world in which tax administrations operate: taxpayers' operations, communications and accounting systems are under constant development. But also the importance of ICT for bulk processes, service delivery, compliance risk management, audit and the fight against tax fraud is immense.

The past years of CIAT General Assemblies and Technical Conferences have demonstrated many excellent examples how tax administrations deal with these major developments: smart use of ICT in organizing business processes, in communicating with taxpayers, in providing service to taxpayers, in gathering information and in e-invoicing, an area in which CIAT has been particularly active and fruitful.

This contribution is about "tax audit in the digital age". The tax audit is one of the instruments used in the compliance risk management

strategy of a tax administration. Therefore, in this presentation, tax audits are put in the context of this strategy.

The first chapter describes the organisation of the Netherlands Tax and Customs Administration. The second chapter summarizes Compliance Risk Management: the risk management strategy of the Netherlands Tax and Customs Administration. The use of ICT different phases in the compliance risk management strategy are described in the following chapters:

- gathering knowledge and intelligence (chapter 3) for risk analysis
- promoting compliance and making agreements about accounting software (chapter 4)
- ICT in tax audits (chapter 5)

These chapters also highlight international developments.

## 1. INTRODUCTION: A BRIEF DESCRIPTION OF THE TAX AND CUSTOMS ADMINISTRATION OF THE NETHERLANDS

The Tax and Customs Administration is responsible for:

- execution of the collection and recovery of the government taxes and customs duties;
- inspection of those aspects concerning safety, health, economy and the environment by the import, transit and export of goods;
- collection and recovery of the employee and social security insurance premiums;
- execution of the income-related contributions under the Healthcare Insurance Act;
- enforcement tasks in the area of economic regulation and financial integrity;
- setting the levels of benefits and paying out benefits;
- collection and recovery for third parties for a number of taxes, duties and other receivables.

Around 28,000 people are employed by the Tax and Customs Administration in the primary and support processes.

## 2. COMPLIANCE

### 2.1 Introduction

The Tax and Customs Administration fosters compliance by delivering appropriate provision of services, by exercising adequate supervision and, if necessary, by enforcing the observation of administrative and

criminal law. In its dealings, the Tax and Customs Administration places both citizens and businesses in a central position and assumes an attitude of trust where this is rightfully deserved. The Tax and Customs Administration matches its approach to the attitude and motivation of the citizens and businesses regarding compliance. From the variety of instruments available, the Tax and Customs Administration chooses those which contribute the most in terms of compliance. This is called compliance risk management. This approach is therefore aimed at influencing behaviour. Moreover, as many processes as possible are being digitalised and standardised.

Compliant behaviour manifests itself in:

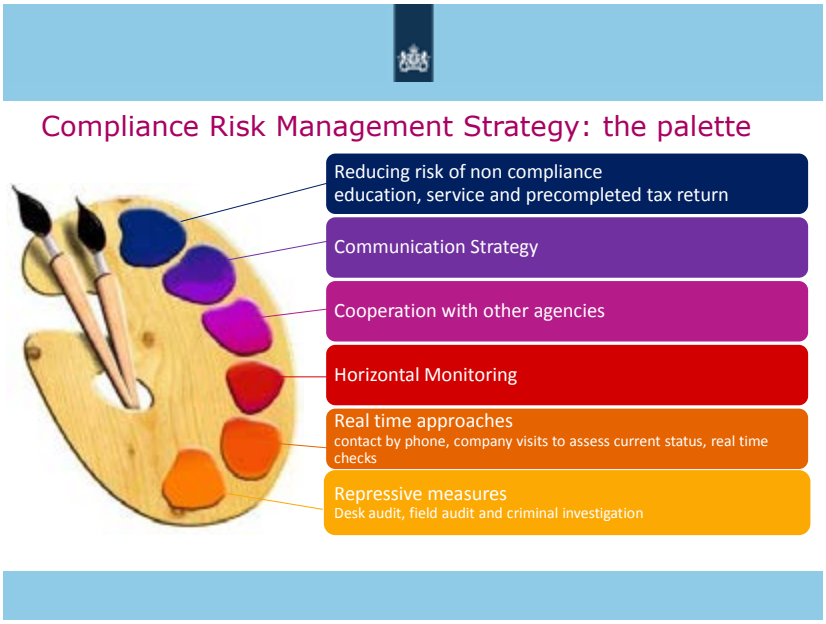
- registering oneself (rightfully) as taxpayer;
- filing one's tax return (on time);
- filing one's tax return correctly and fully;
- paying (on time).

### 2.2. Compliance risk management

The set-up of the compliance risk management strategy is based on influencing/improving the compliance behaviour. In order to achieve the compliance objective as effectively and efficiently as possible, the Tax and Customs Administration has a broad range of enforcement measures available (which can be split roughly into supervision and service provision instruments) and is required to make choices under its enforcement task: choices concerning fiscal subjects, target groups, enforcement instruments to be used, etc. Making choices takes place according to the concept of compliance risk management.

Compliance risk management: the conscious and considered choice, based on knowledge concerning subjects, surroundings and risks, together with the help of costs and benefits analyses, for which instruments (and in which combination and to what depth) should be used in order to achieve the compliance behaviour, or otherwise to support good behaviour. It is crucial to choose the approach that provides the greatest possible effect with the least possible means. This concerns not only the fiscal risks and financial interests, but also issues involving political and social impact.

Compliance Risk Management at a glance:




Critical success factors of the approach include:

-horizontal
-current
-visible
- in collaboration with other enforcement agencies

### 2.3 European Commission

The European Commission's Fiscalis Risk Management Platform has published a Compliance Risk Management Guide, which lays the foundations for the compliance risk management strategy adopted throughout Europe. This Guide (in English) is available from the European Commission's website: http://ec.europa.eu/taxation_customs/resources/documents/common/publications/info_docs/taxation/risk_managt_guide_en.pdf

The Guide makes a distinction between five phases of the compliance risk management
strategy:

1. Risk Identification
2. Risk Analysis
3. Prioritisation
4. Treatment
5. Evaluation

These five steps jointly form a systematic process which tax authorities use to make a carefully-considered selection of the enforcement instruments they shall deploy to promote compliance and in the event of non-compliance. These selections are based on the tax authorities' knowledge of taxpayer behaviour and their available capacity.

Promoting compliance is one of the tax authorities' strategic objectives. They need to select the instruments they will deploy with care, whereby they make their selections on the basis of the approach that will be the most efficient (lowest costs) and most effective (best results). As the use of the audit instrument costs both a great deal of effort and time its deployment needs to focus primarily on non-compliant taxpayers.

Tax authorities are increasingly opting for instruments which they can deploy to promote compliance at as early a stage as possible, namely simple regulations and the education, engagement and involvement of taxpayers.

The OECD's Forum on Tax Administration has also carried out a great deal of work in this field in recent years and has published various reports of studies, mostly of the business segments: see http://www.oecd.org/site/ctpfta/productspublications.htm.

## 3. KNOWLEDGE IN THE DIGITAL ERA

This contribution reviews a number of examples of the manner in which the Netherlands Tax and Customs Administration has deployed digital options in its compliance risk management strategy.

Knowledge is of great importance to the pursuit of an effective compliance risk management strategy. The EU makes a distinction between three forms of knowledge, namely data, information and intelligence. These jointly form the knowledge basis that in part determines the selections tax authorities make in their compliance risk management strategy.

Tax authorities are making increasing use of the digital options that are now available to them, such as the automated retrieval of data from taxpayers and third parties (data) and the deployment of sophisticated data for analyses.

Two examples are discussed below.

### 3.1. Contra-information

Banks and insurance companies employ automated systems to submit annual balance and interest information, by tax reference number, to the Tax and Customs Administration by no later than the end of January of the next year. The Tax and Customs Administration needs this information for its risk selection, pre-completion of tax returns and compliance with the obligations laid down by the European Savings Directive. The submission of this information is a statutory obligation.

### 3.2. Analysing external sources: searching the Internet

An effective compliance risk management strategy also makes sophisticated use of the information available from external sources. The importance of the availability of adequate tools increases with the amount of use of these sources. The Netherlands Tax and Customs Administration develops and makes use of these tools in the Internet Service Centre, a Centre where “web detectives” devote their full time to searches of the Internet. The Xenon web robot is one of the Centre's most important tools.

#### Background

Over the past number of years the volume of (taxable) activities taking place on the Internet has increased. Therefore, the development of an automated instrument for the detection of those taxable activities has become necessary. A web robot, XENON, has been developed by the Netherlands Tax and Customs Administration and is in use since 2004.

The Xenon project consists of methods, techniques and aids which make it possible to investigate phenomena and to control risks associated with the Internet and with Internet-based e-commerce and e-business.

The Xenon project is also developing software to support this approach. This involves the development of three prototype tools: a search tool, an identification tool and a monitoring tool. The search and identification tools, have already been fully developed into working programs.

#### Objectives

XENON detects unknown taxpayers as well as other probable non-compliant events such as the unauthorised use of brand names or illegal diversion of trade.

XENON has three main parts:

(1) Basic Fiscal Search tool (Trainer). With this tool one or more profiles can be set up.
(2) Web robot (Crawler). The web robot searches the Internet for sites that meet the profile. Parameters can be set to determine how deeply links have to be followed, how many sites have to be found as a maximum and how long XENON has to search the Internet.
(3) Web Identification Tool (WebID). WebID supports the identification of the websites owner.

**Operation**

XENON operates as follows:

- with a few examples, an expert shows the XENON-'trainer' what to look for;
- based of these examples, XENON creates a profile, which can be refined if necessary;
- after the final profile is created, the Crawler enters the Internet to search for a pre-determined time or a pre-determined number of sites that meet the profile;
- the results are filed and can be analysed;
- with WebID a 'probable site owner' is identified.

**International co-operation: TAFEIC**

The Netherlands Tax and Customs Administration co-operates closely with other revenue bodies in this project, notably Her Majesty's Revenue and Customs in the UK.

From 2013, the Netherlands is leading a project in the European Union called TAFEIC (Tool Against Financial and Economic Internet Crime) with the following objectives:

- To extend and reinforce the existing European network of Xenon users, the fiscal internet inspection teams;
- Setting up collaboration between tax and police, to detect and eliminate fraudulent activities;
- Extend knowledge about how to make strategic choices between prevention and punishing criminal activities in comparison with actual legislation;
- Developing methods and tools for permanent searching, monitoring and analyzing of suspect activities on the web.

The three year project is expected to deliver the following results:

- Toolset for permanent search, monitoring and analyses of suspect activities on the web;
- Extend and reinforce the existing European network of internet inspection teams;
- Create cooperation between audit teams of both Police and Tax.

## 4. PROMOTION OF COMPLIANCE & THE USE OF IT

### 4.1. Promotion of compliance

The tax authorities' strategic objective is to promote compliance. Tax authorities are increasingly seeking options that enable them to promote upstream compliance (“right from the start”) as an alternative to conducting retrospective audits and making re-assessments. This prevents downstream problems and makes it easier for taxpayers to comply.

During the past years the OECD has carried out a variety of studies in this area for both the Small and Medium-Sized Enterprise (SME) and Large Businesses segments. The "Right from the start” concept has now been drawn up for the SME segment, and a report on the cooperation and links between the Tax and Customs Administration, SME segment and other stakeholders was published in May 2013. The Cooperative Compliance report was also published in May 2013, which contains a framework describing the approach towards the Large Business segment[1].

Also in this area of compliance risk management ICT plays an important part: businesses increasingly keep their books and records in automated systems; developments in cloud computing are an important development for tax administrations, both from a perspective of opportunities for “right from the start” and from a risk perspective.

### 4.2. Forum on Tax Administration

In 2010, the OECD's Forum on Tax Administration van de OECD published a number of Guidance Notes which contain guidelines for cooperative compliance programme standards to be agreed between tax authorities, software suppliers and businesses. The international uniformity of these standards is of great importance to both tax authorities and the business community. The Netherlands Tax and Customs Administration welcomes the opportunity to make use of these standards when reaching agreements with software suppliers and the business community.

1 *http://www.oecd.org/site/ctpfta/listofftapublications-bytopic.htm#comp*

A brief summary of the guidance notes derived from the Tax Compliance and Tax Accounting Systems introductory note published by the FTA (http://www.oecd.org/ctp/administration/45045662.pdf) is enclosed below.

1. Guidance and Specifications for Tax Compliance of Business and Accounting Software (GASBAS)

http://www.oecd.org/ctp/administration/45045662.pdf

The GASBAS guidance note describes in general terms the standards that should be applied in the development of tax accounting software and the key controls that are expected from a tax perspective. It sets out the high-level design principles covering the processes found in a typical computerized business accounting system, including the integration of internal and tax protection controls; procedures to ensure the reliability of electronic records; and the facility to export data for further analysis. It also demonstrates how tax audit processes can be carried out with greater reliability and in such a way that costs to both revenue authorities and businesses can be minimized, and provides guidance on how the principles may be implemented in practice.

This note also sets out a specification for controls, functions and audit reports for use in the development of tax accounting software. This includes the facility for both self-auditing of data and its download for external audit testing including use of the OECD Standard Audit File-Tax.

The GASBAS guidance note is relevant to the following components of the internal control framework: risk assessment; control activities; and information and communication.

2. Guidance for the Standard Audit File – Tax (SAF-T) version 2.0.
http://www.oecd.org/ctp/administration/45045602.pdf

SAF-T is a file containing reliable accounting data exportable from an original accounting system, for a specific time period and easily readable by virtue of its standardisation of layout and format that can be used by external auditors and revenue body staff for compliance checking purposes.

3. Guidance for the Standard Audit File – Payroll (SAF-P) version 1.0.
http://www.oecd.org/ctp/administration/45045611.pdf

SAF-P is a file containing reliable accounting data exportable from an original payroll system, for a specific time period and easily readable by virtue of its standardisation of layout and format that can be used by external auditors and revenue body staff for compliance checking purposes.

4. Guidance on Test Procedures for Tax Audit Assurance.
http://www.oecd.org/ctp/administration/45045414.pd

This guidance note looks at the role compliance and substantive testing plays in the achievement of audit assurance by auditors, highlights some of the types of test that may be employed and examines the overall aims of a test programme.

### 4.3. Agreements on accounting systems

Businesses increasingly employ software in keeping their accounts. The Dutch obligation imposed on businesses to keep accounts encompasses the following:

- keeping accounts of the operations in a manner such that the rights and obligations are demonstrated at all times.
- Although no requirements are imposed on the design of the accounts, they must always be tailored to the requirements the business imposes on its accounts. Consequently, the method used to keep the accounts and the minimum amount of information needed to control the business processes are both determined by the nature of the business.
- For this reason the design of the accounts is influenced by both nature and size of the relevant business. This means that the stringency of the requirements imposed on the design of the accounts increases with the complexity and size of the business.
- The retention period is seven years.
- Audits of the accounts must be feasible within a reasonable period of time.
- The accounts must be accessible and the entrepreneur is at all times required to cooperate in ensuring that an audit can be conducted in the short term.

ICT developments, self-evidently, exert a great influence on business accounts: these developments include integral accounting systems, Enterprise Resource Planning Systems, automated internal audit processes and e-invoicing.

Tax authorities are increasingly reaching agreements with entrepreneurs and software suppliers which are designed to promote compliance and reduce the compliance costs incurred by businesses (by limiting the need for retrospective audits).

### 4.4. Point of sales system quality mark

**Introduction**

Point of Sales systems are an essential element of the accounts of businesses active in the retail sector: they contain the original data about the transactions. Tax authorities all over the world are establishing that advanced techniques are being used to perpetrate fraud by suppressing electronic sales revenue. These systems also influence the records of sales in the accounts. What are referred to as Phantomware and Zapper skimming modules are being used to evade tax (corporate income tax, income tax and VAT) and perpetrate forgery.

Details of this global risk have been drawn up by the OECD's Task Force on Tax and Crime and have recently been published in a report which is available in a number of languages : http://www.oecd.org/ctp/crime/electronicsalessuppressionathreattotaxrevenues.htm.

This reveals that tax authorities all over the world are missing out on tax revenues as a result of the use of advanced systems. The report contains guidelines for the detection of skimming modules. This issue is also on the European Union's agenda. This form of fraud can be encountered anywhere in the world and, consequently, sharing information and searching for a common approach are both of great importance to combating the problem.

The Netherlands Tax and Customs Administration has intensified its supervision of point of sales systems. The Tax and Customs Administration estimates that about 15% of entrepreneurs employ a point of sales system with a skimming module that conceals portions of the turnover from the tax inspector. A number of criminal investigations have already been carried out in recent years in which, subsequent to the detection of fraud, a further in-depth investigation was carried out at other users of the system, as well as of suppliers and manufacturers. A voluntary disclosure scheme has been drawn up for the users of point of sales systems that can be used to perpetrate fraud.

Within the Compliance Risk Management strategy a variety of instruments are used. In parallel with the repressive approach described

above, the Tax and Customs Administration is also seeking cooperation with the relevant stakeholders, such as manufacturers and suppliers. Within this context the Tax and Customs Administration, manufacturers and suppliers signed a letter of intent in April 2011. The suppliers and manufacturers have formed the Stichting Keurmerk Betrouwbare Afrekensystemen ('Reliable Point of Sales Systems Quality Mark Foundation'), membership of which is open to manufacturers, suppliers and resellers. Their point of sale systems are entitled to bear this Quality Mark when they comply with the requirements drawn up in cooperation with the Tax and Customs Administration. The requisite inspections are conducted by independent experts. The first results from this form of "smart cooperation" were visible in January 2013, when Commissioner Peter Veld presented the first of these quality marks.

This Quality Mark guarantees a closed point of sales system. The technology prevents abuse and protects the entrepreneur from undesirable alterations of the data. The Quality Mark promotes the confidence of the bank, Tax and Customs Administration and accountant in the reliability of the data supplied by the point of sale system.

The Tax and Customs Administration takes account of the entrepreneurs' use of a point of sale system with a quality mark in its supervision. As the Quality Mark provides for checks and balances, tax audits can be conducted more rapidly.

## 5. IT IN TAX AUDITS

Tax audits are an important part of the Netherlands Tax and Customs Administration’s compliance risk management strategy. ICT developments are a major part of this instrument. In the Netherlands, software developers and the tax authorities have developed the so called Audit file in which business taxpayers can gather the most important information. This makes preparing for the tax audit easier. In executing the tax audit, the knowledge of ICT is vital. As noted earlier, businesses keep their books and records electronically and it is very important that IT expertise is applied in tax audits.

### 5.1. Preparing for tax audits with the Audit File

Collecting and ordering the data the Tax and Customs Administration needs for a tax audit is one of the entrepreneur's most time-consuming tasks when preparing for an audit. In 1999, the Tax and Customs Administration developed the Audit File to reduce the administrative

burden imposed on entrepreneurs. This Audit File contains most of the data required for the audit. Technical progress in the intervening years subsequently resulted in the XML platform's development of the XML Audit File Financial. This platform is based on a cooperative arrangement between the Samenwerkende Registeraccountants en Accountants-administratieconsulenten (‘Association of chartered accountants and accounting and tax consultants’), software suppliers and the Tax and Customs Administration.

The XML Audit File Financial enables entrepreneurs to make maximum use of the opportunity to exchange data between the various standard packages used in accountancy practice.

The Audit File is currently supported by most accounting software packages used in the Netherlands.

### 5.2. Using computer assisted audit techniques & the expertise of IT Auditors

One of the basic principles of tax audit in the Netherlands is that a tax audit should be based as much as possible on computer assisted audit techniques. For the planning and execution of the audit, the possibilities offered by information technology are used as much as possible. Specially trained IT auditors assist auditors during such audits.

Most organisations use computer systems (from partly to almost fully integrated business and information systems). This is why it is almost always necessary for the auditor to use them in order to form an opinion on the audit object. If the auditor is not expert enough for this, he can engage specialists like IT auditors. They can help the auditor for example with reading of files and the determination of the reliability of systems and the output of systems. An IT auditor has more knowledge and experience in this area than a regular auditor.

For instance, an IT auditor can:

- help the auditor with reading of files and determination of the reliability of systems and their output
- use the features in the option menu of a standard software package, for example for copying files and creating an audit file;
- create a table of contents of the files or software present
- use audit modules of a software package, as they are or can also be used by internal and/or public accountants.

**Powers**

The tax auditor is allowed to consult electronic records and scanned invoices on the computer systems of the business; this is part of the obligation of a company to keep books and records and make them avaible to the tax authorities. It is also possible for the tax auditor to provide the business with a USB stick or other data storage medium so the business taxpayer can connect it to his computer system himself to copy files on to that medium.

The tax auditor is not allowed to perform other acts on the computer system of the taxpayer because this could cause damage to the original data, the software and/or the hardware. The tax authorities may be held liable for any damage or loss suffered, such as replacement costs, the hiring of IT experts or lost profit as a result of a disruption of the business operations. Liability proceedings or complaints are not only damaging to tax authorities' reputation but may also affect the progress or results of the audit. In short: the auditor will take care not to touch the buttons of taxpayers' computer systems! And he will avoid giving specific instructions to the taxpayer with regard to operating the system as this might equally be seen as acts of the tax auditor.

**Using the expertise of the IT auditor**

Information and communication technology is the whole of technical facilities to collect, process, store and present information. For the tax audit is it very important to understand and determine the reliability of the electronic data processes (EDP). The EDP consists of both hardware and software. The accounts of almost all organisations are more or less automated and make use of IT. So if the auditor wants to gain a good impression of the administrative organisation, he will have to make an inventory of, analyse and evaluate this EDP environment.

If a public accountant audits the company financial statements, he will almost always have already made such an assessment. In that case, it will be more efficient to request this assessment and find out which conclusion this accountant has drawn from it.

In order to assess a complex EDP environment, the auditor can use the expertise of IT auditors. He will surely do so if automation is important for the business processes and therefore for the audit object. However, the auditor continues to be fully responsible for his opinion on the audit object. This means that he must have sufficient (general) knowledge of the automated system in order to schedule and direct the activities of the IT auditor and to be able to assess the latter's findings.

The auditor must be deemed able to assess the separation of duties, the user controls and general IT controls of a simple automation environment. In order to assess the programmed control measures – even if it concerns standard software –, he is usually not expert enough, so that, for many audits, he needs the support of an IT auditor.

This support may consist of, for example, checking whether:

- there are programmed controls which cover the relevant risks;
- the interface files include controls guaranteeing the reliability of the data traffic between computer systems and communication systems;
- mutation reports are or have been drawn up and whether these are or have been assessed regularly and whether the necessary actions are or have been taken;
- there are reject lists and whether these are or have been assessed regularly and whether, if opportune, any actions are taken; for example a plausibility check: if an order represents an amount higher than a certain value, this amount must be approved twice, before the order is executed;
- the automated system includes authorisation tables that correspond with the desired separation of duties. It should not be possible to use software outside these function tables.

Moreover, the IT auditor can be of use by providing the auditor with access to files, such as reading in files in Excel for further processing.

**Basic principles**

1. Four-eye principle

The so-called four-eye principle is used for the automation-related activities mentioned. This means that the IT auditor performs these activities in the presence of the taxpayer or of a person who has explicitly been appointed by the latter and to whom each of the steps or actions required are explained, unless the taxpayer explicitly states that he does not appreciate this. In that case, this will be recorded in the audit file, just as it is recorded who was present during the activities.

2. Copy of data file

It is usually not necessary for an auditor to call in an IT auditor in order to request standard data. In many cases, it will be sufficient for the auditor to point out to the person obliged to keep accounts that he is obliged to provide information, to set up accounts and to cooperate. This means that the auditor may ask for a copy of a data file. Moreover, this

means that the taxpayer must also provide the necessary information about the set-up and functioning of the accounts. If necessary, he must arrange for (internal or external) IT support himself.

In addition, the taxpayer is obliged to set up the accounts and cooperate in such a way that the auditor can (digitally) perform the audit within a reasonable period of time.

3. Reasonable period of time

Of course, the auditor must observe the principles of good governance, such as giving a reasonable period of time in order to provide data. Reasonableness depends on the situation. The principle of proportionality may also apply here. For example, if the costs – both absolute and relative – for remedying certain defects in the computer system are too high, compared with the interest for the audit department of the Tax Authorities. In such a case, the person obliged to keep accounts cannot be expected to incur such costs or make such investments.

4. Subjective and objective impediment

If, after the end of the reasonable period of time, it appears that the person obliged to keep accounts does not meet his tax obligation (to set up accounts and/or to cooperate) and he can also be blamed for this (unwillingness), this is called a subjective impediment. In such a case, the auditor will, as a result, not be able to form an opinion on the audit object with reasonable assurance and he must consult a procedural law expert to see whether, and if so, how it is possible to enforce compliance with these tax obligations.

If the taxpayer cannot be blamed for not having remedied certain IT limitations, this is called an objective impediment. In that case, the auditor will ask the support of an IT auditor. The latter will assess whether he has the possibility and expertise to perform these actions, or whether he can (temporarily) remedy these limitations.

The IT auditor will perform such activities in the presence of a colleague, but not after the person obliged to keep accounts has agreed in writing to the execution of the automation-related activities. The taxpayer is also asked to be present here, so that each action can be explained to him. This is referred to as the six-eye principle.

Of course, the IT auditor records his actions in the audit file in detail. Finally, he will draw up a brief report afterwards, containing a general description of the activities, the persons present (who are also requested to sign the report) and any problems.

*Lecture*

*Topic 1*

# TAX AUDIT IN THE DIGITAL AGE

**Enrique Sánchez-Blanco**
Head of the International Relations Unit
State Agency of Tax Administration
(Spain)

***Contents:*** *Introduction. I. Tax audit and digital age. II. Tax audit and digital age. III. Alternatives to use digital possibilities for the benefit of tax administrations IV. Looking to the future. V. Conclusion.*

## INTRODUCTION

If the 19th century was famous for the steam engine, the 20th century should be known as the transport and communications century; we refer to both the facility and speed of the increasing transport of people and goods as well as the distance communication of images and sounds. Consider the substantial change that has had in our lives the use of automobiles or the possibilities offered by the existence of airplanes; in supermarkets we can buy perishable goods produced in the most remote countries and can have breakfast in a continent, lunch in another and dinner in a third. And what about remote communications; from letters transported by boat and the exclusively professional photography from the 19th century, the 20th century introduced the radio, television and the telephone. In this century we know the explosion of mobile phones.

In the last decade of the last century a momentous change is produced with the massive use of a new representation technique of the reality that we call the digitization.

We can consider that the digital age starts with the popularization of the use of personal computers and the emergence of digital photo machines, and was confirmed with the expansion of the Internet. The evolution of digitization has invaded our lifestyle, and with just a simple look to our pockets we can verify this: the keys to hotels, credit cards, mobile phones which are much more than just phones, pen drive with the technical conference information...the digital influence is obvious.

It is necessary to fix the scope of this intervention. There is a risk of confusing the tax audit in the digital age with the inspection of the so-called digital economy. In this paper I want to exclusively refer to how the digital age affects our tax audits in general. This is why I do not go into the exciting challenge of how to pay taxes and how to control the digital economy. When I say digital economy I refer to goods and services that are digital: the most "traditional" cases are digital films or books but every day we discover new forms of digital economy; think about "on line" games or more innovative things such as surgeries where the surgeon operates remotely with a computer located thousands of miles from the patient . Where does the taxable event take place? Where the patient is located? Where the surgeon is located? Where the appointment took place? Where the company that billed the services is located? Or where the server is?

But let us go back to our topic which is the tax audit in the digital age.

## I. TAX AUDIT AND DIGITAL AGE

How does the digital age affect our tax audits?
Tax audits continue to have the same goal: to discover and correct the conduct of taxpayers who do not declare or declare wrongly and certainly do not pay taxes in accordance with the provisions under the law.

For tax control purposes, the essential effect of the digital age is that paper-based information becomes digitized information. Far from being a drawback, it can become an opportunity since its transmission, storage and use can be done cheaper, faster, more effectively and this benefits both the taxpayer and the tax administration.

The second important effect of digitization is that communications with the taxpayer can also be digitalized with the same advantages of saving money and time as in the case of storage.

### 1. Databases: the essential product of the digital age

Information is the raw material which the tax administrations work with. Without information, it is impossible to manage a tax system. In modern tax systems, essential basic information comes from the taxpayers' returns. The information provided by taxpayers affects, in many cases, not only their tax bases but third-party tax liability. A taxpayer cost tend to be the income from another taxpayer, the wages paid and the withholdings affect the income tax return of the one receiving the wage, the interests are capital revenue from

who lent the money, the dividends are income from who perceives them...

Before, we received all this information on paper and its storage and treatment were expensive and fairly ineffective. The digital age has meant that these data received and stored on paper, can now be digitalized and "inserted" it in what we call databases.

Make no mistake, a database works as a file but with a capacity for automatizing the data processing. And in order for a file to be useful, it must follow certain rules which allow finding it when we need it; this information should be classified. The science which deals with the principles, methods and purposes of classification is called taxonomy. If we have reliable and well organized information, the tax management capabilities exponentially increase. Against the assertion that a lot of information kills information, I would like to say that what can "kill" is unorganized information and not the amount of information.

## 2. The attribution of information: importance of taxpayers' census

The first requirement that an expert on taxonomy would indicate with tax knowledge is that the data must be properly attributed, so a database that confuses the person is a lousy basis for tax administrations to take advantages of the digital age.

The importance of having a good census of taxpayers is one of the pillars of our administrative organization. The identification of the taxpayer should respond to rules that allow differentiating it from others: a classification only based on the name can become ineffective information concerning those who share the same name and surname; think if someone named José Garcia López, a very common name and surname in Spain, how do we differentiate it from many other José Garcia López, we would have to accept that the reliability of the attribution of information is greatly reduced. Therefore our data storage must be based on a good identification and differentiation of people system.

As the basic data are provided by taxpayers, we must have control systems that ensure, as much as possible, that no errors occur. Software applications available for taxpayers to digitally submit their returns must be designed in such way in order to avoid the most common mistakes. In Spain we essentially rely on the identification number, we even combine it very carefully to avoid errors or falsehoods.

### 3. Telematics communication of returns

While the current technology facilitates the fulfillment of obligations by taxpayers, we take advantage of the benefits of automation. Our first database was fed from the data provided on paper by the taxpayer and was later "recorded" by a public employee. This brought many delays when entering the data from the taxpayers' returns into the database, as well as the possibility to add errors from the employee to possible errors from the declarant.

Today, most of the returns are made using a free software application that produces online or paper returns with a code of points that allows automatically and very quickly to read the information and integrate it automatically into the databases.

An example of this free and online program is the income tax return system, in which taxpayer enter their data, or uses a dump data system from our database, and the application files the returns and taxes. If there is an internet connection, the returns can be sent online, or can be printed on paper, with a code of points containing all of the information and which will be shown on the first page on the envelope, so once the return is received it can be directly read by a scanner equivalent to those products with barcode reading.

### 4. Information from other sources

Knowing that the information is the raw material with which the tax administration works, our strategic position must be to obtain the most useful information that will allow us to manage it efficiently. The digital age has come to assist us in our task. Frequently, the signs of a taxable event can be found in other public or private databases. One of our duties is to be aware of the existence of databases that can be of our interest and look for the information scanned to be able to integrate it into our base and implement contrast systems for detecting undeclared or improperly declared taxable events.

Given that most of the companies and institutions maintain a digitized database for their daily management, it is important to find that information and capture it automatically; examples of this are the Social Security databases or databases of the General Traffic Directorate for vehicle registration.

Some large companies, such as banks and energy companies, have a database which is very useful for the tax administration. In such cases, it is very important that our requirements for information are answered

through an agreed digital file, allowing the automatic integration of information in our database.

Let us remember the traditional hand-written and bound accounting books and think of the change that supposes receiving accounting entries on paper, or getting a digitalized copy that allows us to carry out accounting analysis.

What to say in case of electronic invoicing, on which Latin America has progressed very much, and which transmit online the invoice data to the tax administration. To have available the information issued or received immediately was a science fiction dream for inspectors 20 years ago, today this is a growing reality.

Therefore we must conclude that on the digital age we should force, or at least encourage, the digitization of all documents and records which, by law, the tax administration can have access to. And let's not forget that it also benefits the complying company, which does not seek to manipulate the information, since we will visit it less since on-site verifications will not be so necessary.

**5. The information is requested in order to use it**

In the previous paragraphs we have described the importance of having digitalized and organized information, but the purpose of taxes is not annoying the taxpayer by asking for information, but to obtain the payment of taxes resulting from the taxable event.

Therefore, the inconvenience to the taxpayer for demanding a more complete and accurate information must be less invasive to compliers and more effective on the non- compliers.

We need to use the information to detect those who do not declare and those who declare wrongly. And once the non- compliers are detected; our duty is to react against them.

**6. Massive control and taxpayers' selection**

The databases are to be used. The first actions that we do with them will necessarily be massive.

First of all something that seems to be very simple to do is to try to discover the non-compliers. If the census were perfect, this action would be very simple since we would only have to compare them with those included in the Census. The problem is to have the full and

up-to-date census. Therefore we should not only consider those that must declare and those who do not, but detect the activities of those taxpayers that are not included in the census. As an example relating to VAT; If a taxpayer declares a VAT and gives us an invoice of a subject which is not included in our census, it is our duty to check the accuracy of the invoice and once the issuer is identified, it is required to declare and enter the VAT that has been charged and punish him for the detected breach. Or an example referred to the income tax information from the withholder, for instance the payment of dividends for an amount that exceeds the limits of the obligation to declare, the tax administration should require the taxpayer to explain the absence of the return and if necessary, in order to straighten the situation, the drafting of a report and the imposition of a sanction.

With these examples we have introduced in the taxpayers selection field the use of logical comparison filters tools known as Boolean algebra (and, or, not and yes).

Depending on the qualifying scope of our database we should use appropriate computer tools for the data we want to deal with. In Spain, we started with an application that had 256 parameters and always required, in each case, computer science experts.

But from the numerous databases through relatively squalid and perforated cards of the 20th century seventies, we have gone to a database with many millions of data. The increase of our database and the further implementation of our tax administration made the claims on selection processes to be accumulated and plaintiffs wanting to include more variables than those initially defined in general.

For this reason in the early years of 2000 an "in house" data mining application was developed, allowing to add and combine all the elements of the database, select them and combine them by defining what each user would like. It is a very powerful tool which we have called Zujar and which is in its fourth version.

It is a tool which main objective was the selection of taxpayers but it now also helps to make statistics, risk analysis, studies, and it may even be used for standardized reporting.

The following is an example of its use. There are taxpayers who appear to properly comply, in which the declared data are perfectly reconciled with data from third parties; but this tool allows us to make a comparability analysis of the data declared by a taxpayer with the data resulting from the average of the data declared by taxpayers engaged

in the same activity. A comparison analysis of various costs in relation to sales allows us to identify taxpayers that may be suspicious; why buying twice a quantity of coffee if the sale price is similar to any similar coffee, with a similar turnover? Or we can compare the margin usually applied in a sector, which, in the case of related entities, can become a transfer pricing filing record.

The tool does not exclusively apply to the monetary data because it allows performing analysis of all the data of our database. Again let's look at examples. The comparisons of the number of employees in relation to the sales volume allows knowing the most significant deviations and ask why; Why does this cleaning company invoices the same as the other that has half of employees? Or enter the geographic variable in order to make more homogeneous comparisons. Or consider as a risk factor the fact that other countries have made several questions about a Spanish taxpayer: If someone asks it is because there is something that is not clear, if the questions are numerous, the risk that the lack of clarity is guilty increases; Are we in front of a risky taxpayer that requires an intensive inspection?

The tax agency of Spain has taken the strategic decision to develop a data mining computer tool for our tax computer department rather than purchase licenses for the use of data mining applications developed by specialized companies; we believe that it was a wise decision. One of the basic reasons is that there is no need to pay annual licenses fees, which we appreciate specially in times of budgetary restraints. Another reason is that we are not dependent of third parties to adapt the tool to new developments or extensions of the database or to use them as a base or combination with other tools. And finally, we believe that our strategy for developing "in house" applications is much cheaper than to entrust it to a third party.

These filtering software performances that are made with data mining tools as it is the case of our Zujar will give us listing of taxpayers with inconsistencies; some of them are easily solvable by a request and the delivery of certain documents, others can lead us to a control in depth.

The Zujar can also be used to select taxpayers with the sole purpose of receiving a request of information or provision of documents to be used in another file.

## 7. Communications with the taxpayer: the opportunities afforded by the digital age

One of the problems that we were experiencing in the Spanish Administration was the cost and lack of effectiveness of the notifications sent to the taxpayer. The use of the traditional postal communication supposed to use paper and pay the cost of the mail.

Notifications in hand or with return receipt increased much more the cost and there was the risk that the taxpayer was absent and we had to use another expensive procedure for publishing it in the official bulletin.

The use of the internet has led to a substantial change in the use of the traditional commercial documentation. Today's orders are generated online, either by inserting the offers directly on the website of the vendor, or by sending them by email.

The Spanish administration has seen the opportunity to use the new digital age to solve the taxpayer's notification problem by reducing the procedure and making it much more effective. The Spanish legislation has incorporated the requirement that businesses have an electronic mailbox, which communicates to the Treasury, where notifications will be sent. The taxpayer is obliged to open the corresponding mailbox on a regular basis; otherwise the law considers that after a few days the notification has occurred.

This is a two-way system as it opens the possibility for the taxpayer to attend and respond, where appropriate, the applications for the administration by e-mail or through the use of the electronic office. The electronic office is a kind of virtual office on the internet, as a web page of the companies, allowing the interaction with citizens, asking, submitting documentation, reports... open 24 hours, 365 days of the year.

To reduce the pressure on the taxpayer, complaining of having to open the mailbox every day, the taxpayer has the possibility to communicate that during certain days the mailbox would be closed for the purposes of the notification; the taxpayer can take vacations for a few days without worrying that when returning a notification has arrived and that deadlines are running since then and has not attended it prejudicing their rights. This softening measure has helped the obligation to be better accepted.

The possibility that the taxpayer has to provide information in electronic files sent via email or presented at the virtual headquarters the

administration helps the taxpayer not to move or make photocopies or queue in times of affluence. For the administration the benefits of reducing the storage space and especially the possibility of analyzing the information with software applications are obvious.

## 8. The risk of manipulation of information digitally delivered or obtained

When the Administration argues with the taxpayer, it has been claimed that the digital documentation provided or obtained had been manipulated, and since they were not the originals so they could not be used as evidence. Digital documentation received or obtained by our computer services from the taxpayer must be analyzed. During the computer files opening procedure and review there was a manipulation of information which leaves certain computer trails. The manipulation did not suppose that the information was changed, but the truth is that the computer file had been opened to review the information. With a procedural argument, the defense of the taxpayer argued in court that the examination was not effective because there was no record of what the initial information was; They said that the Administration had manipulated information so it was not recorded what information had been actually delivered or obtained.

After the appearance of the first problems our computer forensics experts established a new Protocol to ensure the stability of the information provided or obtained; at the time in which it was delivered or was extracted from the taxpayers computer, their 'fingerprint' was required, that algorithm which ensures the contents of a file. If they are manipulated, this algorithm changes the original file is a copy of the file and is provided to the inspection team so that it can open it. The legal evidence will always be referred to the computer copy that is preserved in the record with fingerprint obtained in the presence of the taxpayer, but officials can use one copy for their investigations and analysis. It is like working on a copy on which notes are written.

Other risks of the digital age are certain copies of returns or certificates from tax administrations with a great appearance of veracity delivered by taxpayers, from other administrations. To avoid falsification of such documents, today at the footage of these certificates, a 16 alphanumeric characters verification code is added. Anyone can access the Tax agency website and enter that code to check the veracity of the document provided. This procedure is especially relevant at the international level where a fairly frequent use of false certificates of residence was detected, or for being informed of the payment of taxes.

## II. ELECTRONIC ADMINISTRATION: PAPERLESS ADMINISTRATION

A 2007 Law regulated the electronic administration. The Administration's strategy is to go towards a paperless administration. The law has established the right of the Administration to get electronic images of any document provided by citizens and has established that the electronic image has the same validity as the original ones that have undergone this digitalization process that will ensure their authenticity and integrity.

In addition to that validity, the Law authorizes the destruction of originals that have been electronically copied.

### 1. The information requested from third parties: special case for requesting bank accounts movements

Within the tax audit it is very common that the inspection attempt to verify the reliability of the accounts by contrasting the bank accounts movements. The requirements in this case are individualized and require certain administrative authorizations.

The information in these cases usually does not exclusively refer to real data accessible from any computer in the financial institution but in many cases request information for periods no longer online. The tax agency, to facilitate compliance by the banks, has agreed with major financial institutions a Protocol for running computationally the request to the financial institution, and to make sure of the veracity and correction of the request, and has also agreed on a standard format for online transmission of that information. This format avoids questions on the interpretation of the data while allowing analysis and control tools.

The implementation of this procedure resulted in a remarkable decrease in the workload for the financial institutions engaged in this task. Likewise it has been established that this information used by the tax administration effectively reduces errors and increases the productivity of officials.

### 2. Computer tools to facilitate the reconciliation of the information

We have seen how in the digital age the volume of available and useful information has increased. We always have to consider the problem of the attribution of information to a particular subject and the importance of the censuses of taxpayers with the individualized prevision of the

tax obligations that a taxpayer must comply with. We have tax returns filed by taxpayers and information data based on the third parties returns. And finally we are looking for information and documents that the taxpayer must have at our disposal and that we can get through requirements to third parties or through the inquiry in public sources. Once in possession of all of this, the inspector must organize the information and analyze it in order to confirm the taxpayer returns or report the no submission or incorrect fulfillment of the returns.

The digital age offers us tools that can facilitate our task. Instead of grid filled with columns of numbers and strips of the machines calculate full of numbers and brands of conciliation, now the tax agency of Spain has a computer application that makes these operations for us. It is a pandata application in which data from different sources are entered in order to reconcile the information introduced.

The returns have to be based on the accounting and they must respond to the support documentation. This in part is verifiable through the information provided by third parties (withholdings, invoicing, commissions, transport, services...) which must also be based on the accounting.

The application that has been developed is called Prometheus. The application receives the data and analyses them looking for reconciliations and discrepancies. There are a series of analyses already preset, such as the volume of sales in relation to the VAT sales or VAT purchases volume, or a cash flow analysis, but the application allows the user to make the inquiries deemed appropriate and gives a report on the results of its analysis.

The discovery of discrepancies helps the inspector to focus on more problematic elements, avoiding losing time on calculations that a computer program can do.

### 3. The electronic file: the default procedure

Another advantage of the digital age in the inspection procedure in Spain derives from the need to maintain the electronic file. From the selection procedure, the designation of consulting actuary, the summons of the taxpayer, the proceedings, and reports, all this must be done by completing the documents and recording the actions in a computer application that sorts the procedure. This allows the headquarters to know at what stage is the procedure and gives the clerks forms with preset texts that avoid procedural errors and sets deadlines to meet the different procedures. Since not everything can

be expected, the application facilitates the use of free text where necessary. The paper disappears and everything is stored digitally.

If it was necessary to send a file to an economic administrative court this can be done through an electronic copy which will facilitate the court´s work by using the traditional copy paste tool to write their decisions. This may becomes a drawback since sometimes the parties' abuse of the facility to introduce reports, or doctrine or jurisprudence resulting in excessively voluminous writings wasting much time in reading.

**4. Not all are advantages for the administration**

In this section, I don't want to refer to taxpayers that can also use computers in their day-to-day management, to take advantage by linking their business documentation with their accounting so when they receive an order, the order to the warehouse, billing, accounting and tax return may be linked. That is a legitimate advantage that increases effectiveness and reduces discrepancy costs and risks.

What I want to refer to is the abuses that dishonest taxpayers can make with the help of the computer. Allow me to refer to several examples in which the fraudsters have used elusive digital techniques.

The first case to which I refer has a certain picky aspect. It's about hiding relevant information by a taxpayer who was the subject of a computer turnover. Officials who make the turnover, with their fingerprint, are not the same that analyze the information.

In the case I refer to, the inspector had already a copy of the contents of the laptop of the alleged fraudster. There he expected to find information on hidden sales he was sure that were done. Proofs of orders, payment orders, delivery notes... The computer gave very little information on the type of trade. The hot part was that the computer had a file full of erotic and pornographic photos. The official expressed his surprise to the forensic computer expert of the photos and the little relevant information that was on the computer. The computer expert was surprised by the "weight" of some photos. The weight was excessive even for a high definition picture. Reviewing one of the photos he discovered that clicking on one of the intimate parts opened a file that was the information that the inspector so eagerly sought.

The second case is better known since it has been exhibited in various tax administrations forums. It is known as the zapper or phantom ware case. It is an application essentially sold to bars and restaurants that allows cash skimming at the point-of-sale. The concealment of

purchases and sales refers to those cases in which the customer pays with money distinguishing whether or not the ticket was taken, compared to the cases in which the payment is done with credit or debit card. The program resulted in the decrease of sales that left the lesser trace (in cash and without taking the invoice) combined with a proportional concealment of purchases that had been paid with cash.

The third case refers to banking payments by internet. It was a plot of companies to defraud VAT. The companies were controlled by one person even though they officially claim they did not know each other. One of those companies disappeared without registering the VAT, which had been invoiced and claimed at the Treasury. Other companies act as screens that are interposed between the ignorant buyer and the seller, hiding his suspicious involvement in the fraud. Despite his claims of independence and mutual ignorance, it turned out that all banking movements of different accounts of the various companies had been made in 20 minutes from the same computer as the banks IP addresses from which is bank transfers were requested registered it.

We could go on with examples in which digitization has been used to hide or create appearances that may cause confusions.

## III. ALTERNATIVES TO USE DIGITAL POSSIBILITIES FOR THE BENEFIT OF TAX ADMINISTRATIONS

One of the advantages of the meetings between the tax administrations from different countries is the possibility of sharing experiences. It is not always possible to adopt solutions that other administrations consider to be a success, but the exchange of ideas shows us problems that we were not aware of and sometimes allows us to avoid the mistakes that others have made.

Allow me to show you some applications that have worked to do jobs that are not strictly about tax audit but which are closely related to the tasks that we are committed to do.

### 1. International mutual assistance in the digital age

The internationalization of the Spanish economy has led to the intense development of fiscal relations with other countries. The number of requests for information received from other jurisdictions has considerably grown in recent years. The claims management system was based on communications on paper which generated a physical to be sent to the territorial services of the domicile of the taxpayer to

be controlled. This territorial service made appropriate inquiries, made a report and returned it to the competent authority for information exchange. This control system by the competent authority was based on a file and a registry book based in a file number with successive dates and differentiation of countries.

When the responses arrived, a copy of the file was made and was filed; the original response was sent by mail, fax or courier services. The communication costs were extraordinary and very often there were errors in the shipping address so that information did not arrive or arrived out of deadline. Leaks were not frequent but they involved the risk of violating the disclosure and secret principle to which we are obliged.

The solution has been found through two channels. First the use within the European Union of a secure email network maintained by the Commission. Currently more than 98% of the questions and answers are made using the secure mail. To be able to send scanned copy of reports and documentation, there were resistances to overcome and a large capacity scanner was required. The price of the scanner was below the costs of two weeks of messaging services.

The second part consisted in the design of an application, called Inter, for managing this type of files, that uses the intranet and assumes that the paper does not travel and everything is recorded. This involved a great capacity to seek records by various criteria such as the registration number, tax identification number subject to the demand for information and the person of the other country, name, country, dates, etc. On the other hand it allows integrating this information in the general database from each taxpayer. It also facilitated the response in cases of several questions on the subject. The system has a record of dates which allows reminders when deadlines are close, and the file is still open. And of course allows writing, with easily obtainable data, reports and statistics on compliance deadlines.

**2. Development of simple automatic reports**

It is based on an application called Infonor that allows producing reports on a specific taxpayer with data from the requested database. It is to respond requests from courts, or other frequently requested situation reports. Since almost all of them are structured similarly it was decided to make an application that influence data in a pro-forma on which the report is automatically copied without the need to copy data and without wasting time completing the forms or making transcription errors. With pro-forma already designed, and by checking the boxes

of the type of data and the tax period or periods referred to, a basic report is written. Since it allows adding text, or deleting what is not appropriate, the Infonor report can be adapted to each type of request saving significant amount of time.

## IV. LOOKING TO THE FUTURE

Notwithstanding that the projects are consistent and that they develop very specific applications for our needs, let me give some hints of future projects that are based on the technological possibilities offered by the digital age.

### 1. The e-audits

They are inspections in which the taxpayer allows remote access to his information, which is directly examined by the officers without having to visit the company.

Taxpayers must have their management computerized and accept this type of audit.

This type of audits should be made on subjects about whom there is a certain confidence that all their operations will be reflected in the computer systems.

They are not developed in Spain so I cannot give many technical details. They require the remote access to the main company computer by the inspection team to in order to do the desired verifications. This type of audit requires knowing the applications used by the company to be audited and an analysis on the products and the application possibilities, therefore audit teams must include experts in taxation and also rely on the help of computer experts.

### 2. Video meeting

In order to save time and transportation costs for the Inspector´s activity, this option require available resources, agreement on the time of connection and recording of images and sound. The advantages are increased in particular when it comes to international taxation issues.

In the case of multilateral controls, the preparatory, follow-up and conclusions meetings can be done remotely and if necessary, a digitized delivery system should be prepared for the documentation exchange.

In the case of joint controls, inspectors from the country where the inspection visit is performed may be present in the room with the representatives of the company, while inspectors from the other country can participate by video conference.

In the case of controls on a company which parent or subsidiaries are located elsewhere and should participate in the meetings, their participation could be through video conferencing.

Another case where this type of meeting can be performed is the resolution of friendly procedures in the event of a conflict over application of the conventions rules to avoid double taxation.

### 3. Surfing the internet

This is a last note on the opportunities for inspections in the digital age. Now when we want to know if it will rain, train schedules, where a product is sold, the currency exchange rate, we open our computer, our tablet or our smart mobile phone and we ask. Internet usually gives us the answer.

When we perform a tax audit we should also make appropriate enquiries about our taxpayer on the Internet. The information provided on the web pages of the companies can enlighten us on to where we should direct our Inspector. If in addition the products can be purchased directly on the website, we may receive much practical information that can be important at the time of the inspection.

The value of the information acquired directly through the website must be the same regarding the company's advertising, which is binding for the company with respect to third parties in good faith. Since web pages are changing, it is necessary to report the exact time in which the information was obtained.

I'm going to give an example of the use of this research in the data available on the web on a VAT issue. The taxpayer claimed to sell to a Romanian company with which he did not have any relationship and because of this that VAT should be returned. He insisted that the sale had been agreed by Internet. The consultation on the website of the Romanian company showed us that the phone number for contacts had a Spanish prefix. When the company was asked about the owner of the line and form of payment for the service, we found out that the payment had the domiciled account of the Spanish company with which supposedly he had no relation except online business.

## V. CONCLUSION

The digital age means that both taxpayers and the administration are moving in a new environment. Its development has occurred because it makes life easier to us. Since the information is the raw material with which our tax administrations work, and that the primary element of the digital age is the conversion of information into digital formats that allow a faster, cheaper and more effective storage and treatment, we believe that the digital age offers many opportunities for improving the tax administrations.

We must not forget the risks presented by the so-called digital economy; the traditional principles of Headquarters, place of delivery, permanent establishment, and domicile... are not always the reality of the digital economy making the practical application of tax laws very difficult. The lawmakers will probably have to look for points of connection of the taxable transactions more linked to the reality of the digital world.

The technology based on digitalization is constantly evolving. Tax administrations should pay constant attention to the new possibilities offered, for using them when they suit us as well as to be aware of their use by those who do not want to pay their taxes.

The exchanges of national experiences in professional forums, such as the CIAT Technical Conference, are very useful and practical. The adaptation of national laws to the new technologies must respond to homogeneous criteria otherwise we will create situations such as those reported in the WEPS initiative.

*Case Study*

*Topic 1.1*

# AUDIT OF COMPUTER BASED RECORDS

**Flávio Araujo**
General Coordinator of International Relations
Secretariat of Federal Revenues
(Brazil)

***Contents:*** *Audit of digital registries*

*Presentation PPT*

## AUDIT OF DIGITAL REGISTRIES

The Federal Revenue Secretariat of Brazil (RFB) has experience in the development of various tools for digital auditing in the field of tax administration as it is considered a vanguard organization in this area.

In this area the RFB has been directly responsible for the implementation of the Digital Registry Public System (SPED), which was constituted by the Decree No. 6.022, January 22, 2007, this is one more step forward in the relationship between the Treasury and Brazilian taxpayers.

In general, the SPED consists in the modernization of the compliance system for additional obligations by taxpayers to the tax administrations and supervising agencies using the digital certificate to assign electronic documents guaranteeing their legal validity in their digital format.

In the current phase the Sped includes the following products:

a) Digital accounting records (Sped accounting)
b) Digital tax registration IPI /ICMS (tax Sped)
c) Electronic invoicing (NF-e)
d) Digital Tax registration of social contributions (EFD-contributions)
e) Electronic bill of lading

The following products in the area of Sped are still in development and the information collection is planned to start in 2014:

a) Digital tax registry of IRPJ (EFD-IRPJ)
b) Digital tax registry - payroll (Social)

The SPED will simplify the taxpayer compliance process and integrate tax administrations at the federal, State and Municipal level, thus contributing to the reduction of operational costs

Another important aspect of the Sped is the possibility to gain efficiency in processing the received information, allowing streamlining the analysis and permanent progress in the implementation of digital auditing techniques applied by the Brazilian Treasury.

In the last two decades, the contemporary society has been witness of innumerable inventions that provide access to a universe of information that one could not imagine to achieve. In the scope of the tax administration, this reality was not different. In that context the RFB employees are developing various tools, including the most modern concepts on Artificial intelligence that allow reducing the response time of the countless data crosses in the control field.

Currently, Brazil has nearly 13 million companies listed on the national registry of legal entities, including permanent establishments and subsidiaries. In the macro management field, the tools help for monitoring and for the analysis of compliance with the tax obligations of those companies. In the micro management field, it allows the RFB officials to carry out control activities, perform a fiscal audit, cross data of information coming from various internal sources relating to economic-tax information collection, presented through the taxpayers returns obtained at the same time through cooperation agreements and data collection of the taxpayer or third parties.

By showing the versatility of these tools, the applications allow importing and handling files with accounting information, payroll, tax notes, bank statements and operation of external trade in general; these files follow patterns defined in the RFB internal regulations. Many features related to digital audits are being developed and implemented by RFB technicians performing their work processes, highlighting the following:

a) Artificial Intelligence mechanisms to detect the counterparts in accounting daily records.
b) Mechanisms for automatic assignment of accounting plans numbers to taxpayers according to the standard accounting chart;
c) Graphical representation of accounting flows, presenting an overview of all the accounting as a support tool in the investigation of unusual movements in the company;
d) Application of techniques for detecting fraud in numerical series using mathematical formulas, statistics;

e) Automated mechanisms to examine returns/accounting (old mandatory verifications);
f) Automated recognition of distribution of bank statements that do not require any configuration effort by the user;
g) Audit support tools for Drawback operations
h) Support tools for auditing transfer pricing operations;
i) Support tool for auditing results operations to identify units located abroad (taxation in Universal databases);
j) Tools that grant the user all the flexibility to create reports for data query (dynamic analysis model);
k) Possibility of building database aggregates to be used by selection groups
l) Development of the Income Statement based on accounting information;
m) Vertical and horizontal analysis, balance sheets, ratios, journal, etc.

Thus, in a society on the verge of an information revolution, the RFB plays a leading role, seeking the tax administration performance with fiscal justice and respect for citizens, aiming to be an institution of excellence, and a national and international reference.

*Case Study*

*Topic 1.1*

# AUDIT OF COMPUTER BASED RECORDS

**María Elena Barberan**
National Head of Large Taxpayers Department
Internal Revenue Service
(Ecuador)

***Contents:*** *1. Importance of the topic. 2. Computer-based auditing process. 3. Stages of the computer-based tax audit. 4. Administrative aspects. 5. Technological aspects. 6. Results of intensive controls in large taxpayers. 7. Accounting records in Ecuador's business practice. 8. Special projects in the tax administration. 9. Integral model of structural risk management by processes (MIGERP). 10. Conclusions. 11. Recommendations*

## 1. IMPORTANCE OF THE TOPIC

According to Alink and Kommer (2011), the main challenge of the Tax Administrations is to face the new realities of the world and increasing needs and expectations posed by society. Thus, in recent years, technology has become a fundamental milestone within the field of economic and social development, thus allowing for example, the expansion of international commercial relations and the reduction of costs through economies of scale.

In this sense, technology becomes a necessary, although not sufficient condition for the successful management of a modern Tax Administration. Therefore, the Tax Administrations are forced to undertake in-depth and radical changes in the way in which they administer taxes, considering technology as a constant factor in all their strategic and operational decisions.[1]

Chile, Estonia and Malaysia, for example, are an illustration of the fact that the modernization programs undertaken in the nineties, which included new communication and information technologies with reasonable investments, brought with them substantial advantages such as new internal working methods and new ways of communicating with the taxpayer.

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1 *Alink, Matthijs y Kommer, Victor van (2011) Tax Administration Manual. Netherlands: International Bureau of Fiscal Documentation (IBFD)*

Traditionally, tax audits have focused their efforts in the development of auditing and control processes based on data provided by the taxpayers (the audited taxpayer's own data as well as from external taxpayers) in the returns as well as in the accounting records. However, considering the existence of other extra-accounting information records which are of fiscal and tax interest, there is the need for an audit that will evaluate the reliability of such records and the flow of information toward the accounting system. (Integrity and Timeliness of information)[2].

The computer-based audit should comprise not only the evaluation of the computer equipment, of a specific system or procedure, but also one must evaluate the information systems in general, beginning with the entries, procedures, controls, files security until obtaining the information. One must consider as basis the fact that currently taxpayer information systems integrate heterogeneous data sources, are based on different platforms, technological structures and have strong performance and scaling requirements.

These characteristics present in the systems may constitute a great challenge for the taxpayer, while for the Administration it is essential to carry out Computer-based Tax Audits within the assessment processes, due to the large number of existing transactions and accordingly, the large volumes of stored data which generate a risk in the handling of such records, to the point of being uncertain about the validity of the information that reaches the accounting system and likewise to the Tax Administration.

### 1.1. Scope and contents

This document considers the processes and activities carried out before and after the Computer-Based Tax Audit, as of the entry of the request from the Auditor responsible for the Tax Assessment process, up to the delivery of the final report.

It also mentions certain special projects that have been undertaken in the Tax Administration in order to obtain the best results in the control processes applied at the systems level.

In this way it is expected that the contents shown may serve as guide for understanding the objective of audits in information systems, thus allowing for greater coverage in the face of risks involving tax evasion, tax avoidance and/or delay of the control processes that could be caused by the taxpayers.

2 Taken from the Information Systems Auditing Manual v1.0

## 2. COMPUTER-BASED AUDITING PROCESS

The approach to Computer-Based Tax Audit differs from the traditional audit in the type of control to be analyzed. In computer-based audits carried out by officials from the Internal Revenue Service it is important to consider that each company has different systems; not only because of their functionality, scope or origin, but also because of the following aspects:

- Increase and diversity of Information Technologies.
- Large volume of data.
- Volume of processes.
- Diversity of procedures
- Advanced communication technology.

However, all in general may be considered as a set of programs, files and procedures that are "encapsulated" in the same conceptual design, in the same physical design and preferably, in the same technological platform.

Based on this reality, in 2007 the Internal Revenue Service proposed the creation of a new control scheme through a group of tax auditors specialized in information technology, whose functions were to support compliance with the tax regulations by the taxpayers who used automated information systems, considering that for the tax auditor it was difficult to expand his scope of evaluation to the information systems.

In addition, one must consider the limitations imposed by the taxpayers themselves, by trying to prevent or complicate the adequate control work of the Internal Revenue Service3.

### 2.1. General objective

Analyze and evaluate the INTEGRITY, CONFIDENTIALITY and AVAILABILITY in the generation, registration and issuance of data of fiscal interest processed in the taxpayers' computer-based systems which may be of importance for the Internal Revenue Service.

*3* Taken from the Information Systems Auditing Manual v1.0.

### 2.2. Specific objectives

- Identify risks when reviewing the existence and sufficiency of controls and procedures in the systems to be audited.

- Render more efficient and effective the tax control process when the information is processed through information systems.

- Minimize the risk of tax evasion given the existing limitations in the audits by the control officials when faced with automated information systems and a high probability of manipulation of data of fiscal interest.

### 2.3. Legal base

The Tax Code (articles 96, 97 and 344) provides for the formal duties of the taxpayers and mentions issues related to computer-based accounting records, in keeping with the Regulation for the application of the Internal Tax System Act (article 261) which states that the official in charge of the assessment process may undertake the examination and verification of the accounting records, processes and systems related with tax issues. In addition, it empowers him to undertake examinations and reviews of the computer-based systems which handle information related to accounting and/or tax aspects used by the taxpayer and to obtain, on magnetic or printed media the supports it may consider pertinent for tax control purposes.

### 2.4. Description of the process

- The auditor in charge of the assessment process should include within the first information requirement, the Technical Questionnaire regarding general knowledge of the company under the pre-established format.

- The auditor in charge of the process, through Request for Computer-Based Audit and delivery of the Taxpayer Knowledge Questionnaire and the Technical Questionnaire on General Knowledge will request the Computer-Based Audit as appropriate;

- Every request for Computer-Based Audit must be delivered in the pre-established format to the Supervisor of the Information Technology Team or the Staff in charge;

- Following delivery of the request and Annexes, the Information Technology Team will determine the approximate time required for the Audit and will assign the Auditor specialized in information technology who will be in charge;

- The auditor in charge of the case, to the extent possible, should be present in the first inspection made to the taxpayer within the Planning Stage since it is necessary to be aware of the business and its processes, with a view to recognizing possible computer-based risks;

- In case the Assessment Process is in the Execution Stage, the Computer-Based Audit will be focused on the specific risks that may be determined by the Auditor in charge;

- Upon concluding the Computer-Based Examination, the Auditor specialized in Information Technology will prepare the respective report on the process;

- The preliminary report will be delivered to the Supervisor of the Information Technology Team to undertake the pertinent evaluation and, if necessary, new examinations will be carried out or the Computer-Based Audit will be deemed concluded.

- The Auditor specialized in Information Technology will prepare the memorandum of Delivery of the Report and together with the Report of the Auditor specialized in Information Technology will deliver it to the Auditor in charge of the Case.

## 3. STAGES OF THE COMPUTER-BASED TAX AUDIT

The scope of the Computer-Based Tax Audit states the limits thereof and there should be a very precise agreement between the auditor specialized in information technology and the auditor in charge of the case with respect to the processes to be audited.

Once the specific objectives have been determined, they will be added to the general and common objectives of every computer-based audit: the operation of the systems and the general controls of information technology management.

The time and type of Audit to be carried out depends on:

- The size of the Company
- Type of Business
- Number of taxes to be controlled
- Number of years to be controlled
- Volumes of transactions
- Complexity of the company.

**a) Initial analysis of the auditing environment**

In order to carry out such study the general functions and activities of information technology must be examined.

For this purpose, the auditor specialized in information technology must know the Organization, its operational environment, applications, data bases and files, for which purpose the Information Technology Technical Questionnaire is applied.

**b) Determination of resources required**

The results of the initial study serve as basis for determining the human and material resources to be used in the audit.

**c) Planning**

After assigning the resources, the officer responsible for the audit and his collaborators establish a working plan. Once decided, it is then scheduled. The plan is prepared by taking into account the following, among other criteria:

i) Whether the review should be done by general or specific areas.
ii) Whether the audit is global, that is, covers all processes and systems handled by the taxpayer, or partial. The volume determines not only the number of auditors required, but the necessary specialties of the staff.

Once the Plan has been prepared, the activities are then scheduled. Scheduling should be sufficiently flexible so as to allow for modifications throughout the computer-based examination.

**d) The auditing process**

It consists of the review and evaluation of the taxpayer's controls, systems, computerized procedures and computer equipment, their use, efficiency and security, which participate in the issuance, recording and generation of information of tax interest, in order that an evaluation may be provided with respect to the reliability of the figures stated in the tax returns and the risk existing in the management of the information.

The information technology team, through the development of a methodology and a series of audit tests will evaluate the information

systems that manage information that is relevant or of fiscal interest, with a view to ensuring that purchases, expenses/costs, fiscal credits or debits be documented, recorded (stored in the data bases) and declared correctly. It will also evaluate the complete record of taxable events, especially with respect to the control of inventories and sale and/or service rendering documents, provided that these are maintained through information systems.

**e) Report**

The technical support reports generally have the following structure and contents:

- Introduction, including the objectives (general and specific), the scope of the technical support provided, the period covered, the existing limitations and a summary on the nature and extension of the procedures and methodologies used.

- Observations, recommendations and global conclusions of the technical support staff, expressing an opinion on the existing risks, on the integrity and timeliness afforded by the taxpayer's information systems, as well as the quality of the information to be requested or requested by the Internal Revenue Service. In addition, it is worthwhile mentioning the quality of the controls or procedures reviewed during the audit.

## 4. ADMINISTRATIVE ASPECTS

The Tax Administration has staff specialized on this subject, at the National Directorate as well as in the Regional Directorates, where there are one or several persons that make up the team of auditors specialized in information technology, who execute the previously described process with respect to whatever controls may be necessary.

The work of the Internal Revenue Service's team of Auditors specialized in Information Technology is to integrally audit the computerized systems related to the taxpayer's tax accounting sphere.

The Tax Auditor specialized in Information Technology will have the power to:

- Identify, obtain, evaluate and verify the effectiveness, integrity, availability, reliability and compliance of the information requested by the auditors within the control processes.
- Guarantee the principle of confidentiality of the information.
- Identify the possible risks in processes, systems and information, with respect to attempts at tax fraud or evasion.

- Issue technical criteria that will allow for supporting and/or mitigating the risks identified during the control process.

It should be noted that in the Ecuadorian labor market there is a scarcity of auditors specialized in information technology, as well as training in keeping with the profile of an auditor specialized in information technology, for which reason it has been impossible to cover the demand for computer-based reviews in the assessment processes.

## 5. TECHNOLOGICAL ASPECTS

To ensure that the taxpayer system controls are working adequately it is necessary to verify the quality of information in the system. Likewise, for processing the generated information the following applications are used:

- Excel
- Access
- ACL

This latter tool is a software specialized in Auditing used for processing a very a large volume of information, analyzing the data, sampling, making inquiries and generating reports.

ACL differs from Excel and Access in that it is a software whose main characteristic is to guarantee the accuracy and integrity of the transactional data (one cannot manipulate the source data (information provided by the taxpayer), in addition to the fact that it has no limitations in the number of processed records.

Finally, the lack of tools designed for tax assessment processes implies that the data analysis operational processes within these controls require high response times that delay the effective and timely analysis of these data.

## 6. RESULTS OF INTENSIVE CONTROLS IN LARGE TAXPAYERS

The Tax Administration has a National Large Taxpayers Area which is in charge of the cadaster of the 270 most important companies of the Country. Its main role is to provide follow up and control, through the segmentation of the cadaster into economic sectors and with specialized staff in each one of the sectors. The main functions of the staff are: follow up the tax behavior of the taxpayers, advise large taxpayers and support and supervise the control processes that are carried out in the Large Taxpayer Regional Areas, where there are also specialized teams.

The National Large Taxpayers Area has carried out 17 income tax assessments since 2012 to retail companies that used computerized systems for recording their transactions. It should be noted that the volume of information is huge and they require systems that may allow for storing it and for generating specific reports that feed the inventories and sales modules.

In the computerized tax audit control processes the following common factors have been found, regardless of the year analyzed or the subsector or jurisdiction where the control was carried out:

- The accounts with greater inherent risk are revenues and inventories, since logically these accounts are the basis of the company's business.
- The value declared as cost of the products sold, in the company itself, is determined through a mathematical calculation[4].
- The volume of transactions exceeds the processing capacity of the usual equipment made available to the auditors.
- The control tests lack timeliness since control planning implies the analysis of 3 or 4 year-old periods.
- There is no possibility for testing the company revenues with information reported by third parties, since most of their sales are made to end consumers who are not obliged to keep accounting records or submit detailed information on their purchases to the Tax Administration (transactional annexes or ATS).

## 7. ACCOUNTING RECORDS IN ECUADOR'S BUSINESS PRACTICE

In computer audits, one of the most frequent ones is that of the commercial sector, where the generation of accounting records is automatic, large chains have several interfaces that communicate their systems, thus avoiding manual operations in their records. The volume of sales stored daily implies that the process must necessarily be reviewed through a Computerized Audit.

*4 COST OF SALES = INITIAL INVENTORY + PURCHASES – FINAL INVENTORY*

Below is a description of the verification of this sector, using as example a case where three computerized reviews were made:

### a) Objective of the computerized examination

- Analyze the Technical Questionnaires.
- Interview system technicians and users.
- Recognize the flow of Inventories, Purchases, Sales Invoicing processes and their accounting operations.
- Evaluate the reliability in generation, recording and issuance of data processed in the taxpayers' information systems.
- Verify the integrity of the information provided by the taxpayer during the examination and compare it with the information obtained from the system's front-end/BDD.

### b) Initial analysis

- Verification of the information provided through the Technical Questionnaire and the information compiled from the interviews made to the Technicians and users of the system.
- Comparison of Applications used in the year being assessed vs. the applications used in the current year.
- Review of changes made at the level of policies and procedures, hardware and software; if appropriate a review is made of reports from Self-printers requested to Tax Services.

The following charts show the different applications used by the same taxpayer according to the fiscal year assessed:

YEAR BEING ASSESSED 2008

| No. | APPLICATION NAME | DESCRIPTION | ONLINE INFORMATION | MODULES USED |
|---|---|---|---|---|
| 1 | MegaZ Inventories | Generation of inventories movements, purchases, costs, PVP, physical samples. | Yes | Inventories |
| 2 | MegaZ Accounting | Generation of accounting movements, ledgers, financial statements | Yes | Accounting |
| 3 | MegaZ Human Resources | Human Resources management, Contracts, Attendance Control, Payroll | Yes | Hiring of staff, Attendance Control, Payroll |
| 4 | SuperMarketApplication | Recording of sales through a POS | No | Sales |

YEAR BEING ASSESSED 2009

| No. | APPLICATION NAME | DESCRIPTION | ONLINE INFORMATION | MODULES USED |
|---|---|---|---|---|
| 1 | MegaZ Inventories | Generation of inventories movements, purchases, costs PVP, physical samples. | Yes | Inventories |
| 2 | MegaZ Accounting | Generation of accounting movements, ledgers, financial statements | Yes | Accounting |
| 3 | SuperMarketApplication | Handling of points of Sales | Batch | Point of sale |

**CURRENTLY**

| No. | APPLICATION NAME | DESCRIPTION | ONLINE INFORMATION | MODULES USED |
|---|---|---|---|---|
| 1 | MegaZ (Internal Software) | Supports the sales process (Price lists, margins, scales), physical samples and sales reports | Yes | Sales |
| 2 | JdEdwars | Is a multi-user, web environment, maintains referential integrity. | Yes | Accounting, Manufacture and Inventories |
| 3 | Cygnus | Is a multi-user, client server, maintains referential integrity | Yes | Suggestions of purchase and supply |
| 4 | Evolution | Is a multi-user, client server, maintains referential integrity | Yes | Payroll, Time Control |
| 5 | SuperMarketApplication | Is a multi-user | Batch | Point of Sale |

### c) Analysis of field processes

In this analysis, follow up was made of the systems used and the following information was obtained:

- Process flows (year of assessment vs. current year).
- Interfaces:
  - JDEdwards (does not handle sales, stores the items masters, suppliers, negotiation and purchase prices.
  - Mega Z (Point of Sale Management).
  - SuperMarketApplication (SMA).
- A simulation was made of sales processes.
- Follow up in production environment of generated transactions that intervene in the processes (POS IBM, MegaZ, JDEdwards)
- Follow up of documents corresponding to year being assessed.

### d) Analysis of processes following computerized examination

Following the field work, the following aspects are verified in the office. It is worth mentioning that the results will comprise the report to be delivered to auditing in order to determine the risks arising from this review and to have a general idea of the security afforded by the

system used in the generation of transactions, which will influence the determination of the importance of certain accounts.

- Review of the fiscal rolls or auditing tapes of a cash register, branch and date.
- Comparison with the cash register closing issued, total report of daily closing by branch.
- Comparison with accounting records. (Daily sales voucher).
- Comparison of System vs. Physical Documentation.
- In each of these files the following aspects were verified:
  - Sequential
  - Authorization number
  - Amount of gross sale with Report of CXC detail
  - Total registered as cash
  - Total registered as check
  - Withholdings at the source
  - Totals in Gift Cards
  - Totals in refunds
  - Totals in Credit Cards
  - Sales totals reviewed according to detail of generated transactions
  - Totals in annulled, suspended and recovered transactions

## 8. SPECIAL PROJECTS IN THE TAX ADMINISTRATION

### 8.1. Forensic computer-based audits in the tax administration

In 2008, a digital entitled “SRI: millionaire fiscal fraud to the Ecuadorian Stat” discloses:

> “Investigations carried out up till now determine that this fiscal fraud has caused a detrimental effect of 1.000 million dollars in the past three years. In addition it was discovered that officials and addresses were used by several companies. It was detected that five persons were legal representatives of 625 companies and one of 173 companies; an accountant carried out the same function in 708, three accountants in 1,629; and two stockholders of 50% in 672 and 411 companies. Likewise, there were 640 business entities registered in five domiciles.” (Villarruel, 2008)

One of the computerized threats for the Tax Administration is the information theft or leak, especially in areas where confidential information is handled.

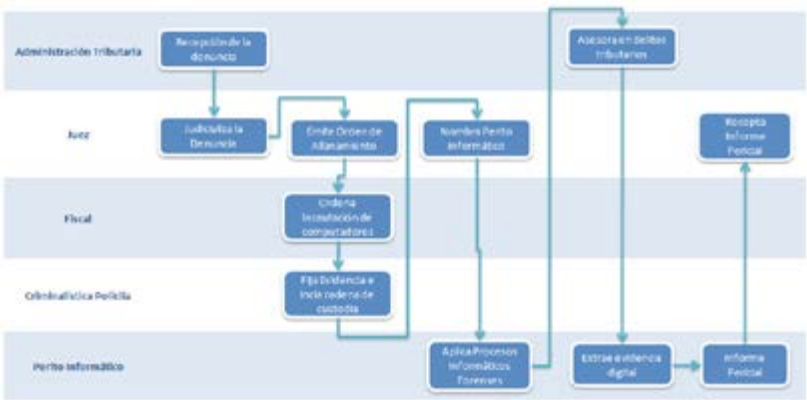
> “There is a high potential of data loss”, according to David Paschich, Cisco’s Web Security Product Manager. “Companies are losing control over who has Access to its corporate network. The simple fact that more employees are using mobile devices

to work and, on occasions, multiple devices means that there is a greater potential of data loss due to theft or loss of a device. ". (Cisco, 2011)

In the Tax Administrations many of these irregularities have been discovered through denunciations, resulting in investigation cases with a reactive approach. Such investigations are consistent with the main objective of the Fiscal Fraud Investigation Area which is: to obtain and analyze internal and external information for the purpose of planning, coordinating and supporting the tax fraud control and investigation actions relative to taxpayer unusual behavior contrary to tax regulations.

In this respect, one of the best practices of the Tax Administration has been to include Forensic Computer-Based Auditing processes, by rendering the denunciation judicial, as an offense detected in the act, in order to obtain the order from a Judge and accompanied by a Prosecutor, Judicial and Criminal Police, confiscate the electronic equipment and devices to obtain digital evidence[5].

Rendering the Procedure Judiciable




Source: Acurio, 2009

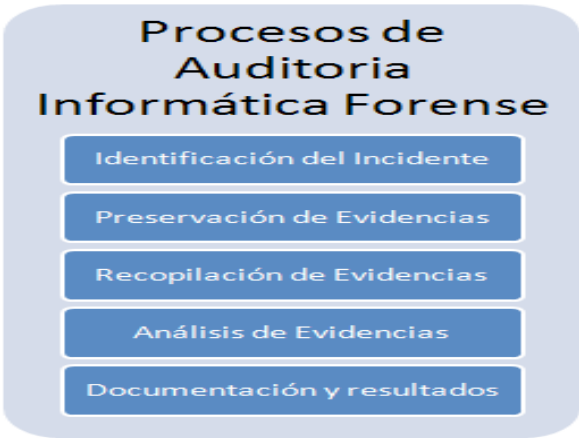
In these cases, the Computer Auditors or Experts of the Tax Administration advise the official Computer Expert which is appointed by the Judge. Counseling basically consists of indicating the confiscated information which is related to the tax offense, through the use of forensic computer hardware, software and processes.

5 The digital evidence: Consists of magnetic fields and electronic pulses that may be compiled and analyzed with special tools and techniques. *(Acurio, S. 2009)*

Another of the best practices is the Computerized Expert Appraisals which may take place in the instruction, inquiry or intermediate phases. In these cases, the computerized expert appraisal is carried out by an official of the Tax Administration duly accredited by the National Council of the Court. In any of the two cases, the process of the Forensic Computer-Based Auditing is followed.

### 8.1.1. Forensic computer-based auditing process

As may be observed in the following figure, the Forensic Computer-Based Auditing
Process consists of five stages:




Forensic Computer-Based Auditing Processes

The first is the identification of the incident, learn about the case and identify the storage devices and means. The second is the preservation of the evidence, which is to continue with the custody chain. The third, compile the evidence, in which stage the data that will serve as digital evidence is recovered, analyzed, identified and extracted. The final one is the documentation and results phase which consists of the preparation and presentation of the expert appraisal report.

## 8.2. Computer-based auditing program for retail companies

In the National Large Taxpayers Area an auditing program is being developed to test in a computerized environment the consistency of the balances of the inventories, revenue accounts and the estimation of the cost of products sold in retail trade companies.

The objectives of this program are:

1. Increase the size of the simple or cover the totality of the transactions that generate the balances of revenue and inventories accounts.

2. Facilitate the identification of accounting inconsistencies or processes that facilitate the assessment of the reasonableness of the balances.

3. Facilitate the identification of adjustments and transactions without economic support.

This project endeavors to solve inconveniences detected in previous assessments such as the inability to identify transactions or processes that overestimate the costs or underestimate the revenues, given an extremely high volume of transactions and the inability to measure the control risk when analyzing taxes corresponding to previous fiscal periods.

## 9. INTEGRAL MODEL OF STRUCTURAL RISK MANAGEMENT BY PROCESSES (MIGERP)

The administration of the tax system is undoubtedly one of the areas within the public sector deserving priority attention and strengthening in a country, since public tax revenues are the source of essential financing of every democratic society. Everyone's contribution according to his capacity is the essence of the very "social contract" from which the State originates.

Although the fundamental objective of the Tax Administration is to collect the necessary resources for the public budget, it can no longer focus its strategy only in controlling compliance with tax obligations, but should also consider the efficient and effective compliance of its processes, based on an integral management model.

This is the new vision that leads us to reconsider the ways of consolidating our Tax Administration. Although the Internal Revenue Service since its creation (199/9 has been gradually focusing on developing the tax culture in the country, with a positive social recognition and permanent increase in collection, the citizens' demands for a better service, the normative and legal reforms that govern the tax administration and the current dynamics of information technologies have led to the analysis and evaluation of the institution's operational management.

The increased needs for a better tax administration, makes the tax administrations grow organizationally, structurally and operationally, although without this necessarily implying a planned growth in all its processes, isolating the main actors that participate in the taxpayer cycle, establishing limited technical definitions that result in non-integrated information systems, thus creating silos of information and lack of a global vision in the tax administration's performance, thereby resulting in undefined roles and responsibilities, little clarity in the products and services delivered and, accordingly, almost null measurement in their evaluation and subsequent improvement.

With complex and little integrated information systems, the technological platform of every tax administration is affected in its physical as well as virtual capacity, thereby resulting in problems of availability and performance of the applications used by the internal as well as external customers and reducing the efficiency and quality of the service.

In its permanent effort for continuous improvement, the SRI began the restructuring process of the strategic, tactical and operational approach, consisting of 4 integrated components: managerial leadership and governability, integrated technological structure, administration of processes and continuous quality management and risk management scheme, endeavoring to create synergy and becoming a logical, convenient and consistent architecture.

The new management model is called INTEGRAL MODEL OF STRUCTURAL RISK MANAGEMENT BY PROCESSES- MIGERP and in general terms these components are described as follows:

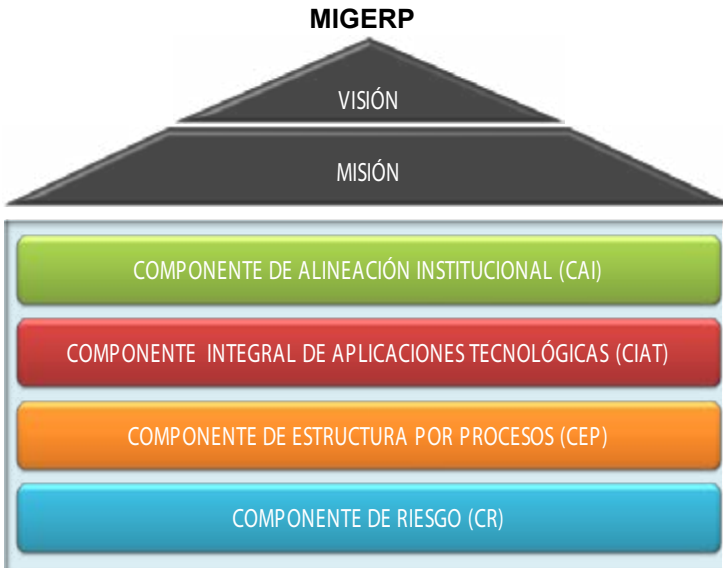
- **Risk component:** Considers risk as the basis of the model and the institution's maximum strategy, at the internal operational level, as its management in relation to the taxpayer.

- **Structure by processes component:** Consists of a structured and logical mapping of each of the institutional processes. This logical mapping added to the formalization in an organic structure by processes, consolidates the second component.

- **Integral component of technological applications:** The technological aspect is one of the strategic factors in the SRI's management. However, there is a significant number of technological applications with a low level of integration among them, which has become an inconvenience that must be solved. The model includes a third component that is consolidated in a global technological solution, which converts the significant

number of applications into 10 integrals, which cover the support as well as management units.

- **Institutional alignment component:** An important component which allows for carrying out in a structured manner the management planning, follow-up and monitoring process and which helps consolidate the governability process is the one called institutional alignment, which is divided into three management levels: strategic, tactical and operational with its own structure and management scheme.




These four components are consolidated in the **Integral Model of Structural Risk Management by Processes (MIGERP)**, it being a balanced structure of Strategy, Processes, Technology and Organizational Administration, with clear actions that may be integrated and carried out.

Standing out in technological innovation within this model is the **Integral Component of Technological Applications (CIAT)**, which endeavors in brief terms: to innovate and integrate the technological platform, reduce direct and indirect costs in compliance with obligations, contribute to the increase in efficiency of the organizations and improve collection through productivity optimization.

The graph below shows the tangible benefits expected to be achieved with the execution of the CIAT:


**Future perspectives**

The field of action of the Tax Auditor specialized in Information Technology is ever broader and ever more evident its importance. That is why controls in the taxpayer systems (especially in the self-printing systems, systems using electronic invoicing in the assessment processes) through time will reduce the scope of conventional auditing. In other words, the automation of tests and the evaluation of the taxpayer computerized systems allow for more effective evaluations, which implies a decrease in audit risk that will, in turn, allow the auditor to devote more time to accounts or transactions with identified risks.

It is of vital importance that computer-based tax audits be held timely, in order that the revised information may have a high level of reliability as regards the quality and system used. This goes in hand with the planning of controls of current and/or concurrent periods.

It is a priority matter to hold annual workshops to establish new testing forms and in this way strengthen the Computer-Based Audits within the assessment processes.

There is a proposal for implementing the Internal Forensic Computer-Based Investigation Laboratory (LIIFI) in the Tax Administration, which initiative endeavors to prevent and face those violations by safely obtaining digital evidence that will serve for undertaking judicial actions in the cases of fiscal fraud investigation.

In addition, an audit program is being developed for the review of the computer-based systems of companies that generate a high volume

of transactions, which should provide a reasonable result with respect to the reliability of the information provided by the taxpayers.

Lastly, the MIGERP project is based on technological innovation through the Integral Component of Technological Applications (CIAT), thereby seeking an innovation and integral reconsideration of the technological platform and the flow of information that enters the Tax Administration, with a view to reducing the direct and indirect costs in compliance with the obligations, contributing toward increased efficiency of the organizations and improvement in collection by means of productivity optimization.

## 10. CONCLUSIONS

- Computer-based audits have been acquiring their own space within the Tax Administration, since most of the companies have systems for managing their information. Thus, it is important to bear in mind that, although the controls of a system are effective, this does not always imply that the resulting information will also be so.

- In companies handling a large volume of transactions, the computer-based audit is essential for the corresponding reviews, thereby rendering the assessment processes more efficient.

- It is important to count on specialized tools for carrying out computer-based audits that may result in a better analysis of the information that may be obtained.

- It is a priority issue that large and medium taxpayers have integral and safe systems which may allow that the review of information by the Tax Administration be automated, thus reducing the control execution time, a lower indirect pressure for the taxpayer and a reasonable certainty regarding the results obtained in the field of activities having a large volume of transactions.

## 11. RECOMMENDATIONS

- Include measures that complement each other and that seek to generate risk and control perception among taxpayers as regards their accounting information and ensuring for the tax administration information with better attributes (compliance, effectiveness efficiency, confidentiality, integrity and availability).

- Provide specialized tools for computer-based audits in order to carry out an effective control from the standpoint of the systems that store information regarding taxes.

- Undertake intensive controls of current years in order that the computer-based tax audits may provide better results in risk identification.

- Have an appropriate annual training system for auditors specialized in information technology, to thus strengthen the field of action.

**PREPARATION SOURCES**

1. Document provided by the Northern Regional Tax Audit Department.
2. Document provided by the Tax Intelligence Department.
3. Document provided by the Planning Department.
4. Information provided by the Fiscal Studies Center
5. Information and analysis carried out by the National Large Taxpayers Area.

*Case Study*

*Topic 1.2*

# RISK ANALYSIS AND AUDIT SOFTWARE TOOLS (DATA MINING)

**Alejandro Burr**
Director
Internal Revenue Service
(Chile)

***Contents:*** *Summary. I. Risk analysis tools. 1. Introduction. 2. Tax compliance risk. 3. Evolution of risk management in the tax administration. 4. Risk management by segments in a tax administration. 5. Risk area. 6. Analysis tools. 7. The future. II. Software for audits: 1. Background. 2. Definition. 3. General objective. 4. Specific objectives. 5. Product characteristics. 6. SADA audit workflow. 7. Benefits. 8. Results. 9. Conclusion.*

## SUMMARY

Within the framework of the present technological development, the role of technology within the tax administrations is fundamental in managing high volumes of information, generated from the taxpayer's behavior.

The great daily volume of data resulting from the taxpayers' obligations has forced tax administrations to modify the strategy and operation for effectively managing their resources.

In this sense, the taxpayers' risk analysis tools play an important role in the detection of unwanted behaviors that otherwise would be very difficult to detect by control officers or could only be discovered once the unwanted behavior has happened.

Also, control support systems - especially those associated to the audit - give many benefits when they are correctly implemented, mainly oriented to standardize procedures, to support resources management, and to leave a registry of officers' actions, that serves as reference for new procedures.

The present document shows how the Internal Tax Service has faced this challenge. On one hand, it describes why it becomes necessary to measure the risk, some examples of the work performed by the Risk Area of the Control Department, and their future challenges.

Finally, part of the experience in the implementation of the Audit Development Support System (SADA), a comprehensive tool for helping the public officer in the control task, will be presented.

## I. RISK ANALYSIS TOOLS

### 1. INTRODUCTION

Evasion and fraud schemes are growing in complexity. The dynamism in their adaptation, modification and transformation, as well as the exponential growth of the information available to tax administrations, added to the fact that taxpayers complete most of their procedures and compliance actions on the web pressure the Tax Administration. Income tax return and VAT from third parties, the taxpayers' own returns for these taxes, the stamp duty and electronic tax documents emission, electronic accounting registries, in the case of micro and small taxpayers (all of the above, in the Chilean case), and many other sources and types of information are now online services. The Tax Administrations have to rely on Tax Intelligence Areas and Risk services to use more effectively and efficiently these new techniques against evasion and fraud, especially when the classic approach requires an intensive previous case-by-case control, through the revision of tax documents, crossing of invoices, expert reports, and many other actions that finally can become unproductive in some cases.

Those new methods and techniques are provided by Data Mining, based on statistics and artificial intelligence, allowing the extraction of useful knowledge, implicit in the available data bases and information sources. Through the models and using data mining techniques, the solution prediction, classification and segmentation problems are approached.

These techniques have been in use for a long time in industries such as Banking and Retail, where they have proved to be effective in risk determination, as for example, the credit risk, and in the application of commercial techniques of profitability and customer loyalty, such as cross-selling (crossed sale).

This document tries to show that these techniques also can be implemented in Tax Administrations and their effects can be measured to analyze their impact in the improvement of compliance levels.
The OECD has defined the risk in Modern Tax Administrations as essential in the definition of innovating strategies to decrease non-compliance levels faced by classic methods.

Chile has been using the experience of foreign tax administrations in risk management, such as the Netherlands, and regional neighbors, Argentina and Ecuador.

Other public institutions, such as the SVS, have been restructured regarding Risk. The private sector has been a pioneer in these matters, especially the Bank and the Retail, that have invested in resources for managing and controlling risks, as essential for creating value for their clients and shareholders.

## 2. TAX COMPLIANCE RISK

Although the definition of risk according to the Real Spanish Academy is “Contingency or proximity of damage”, our Risk Department in the Control Sub-division has adjusted the definition for our institution, as “the probability that a taxpayer does not comply with the tax duties at a given time”. This risk definition sets time limits on the noncompliance by the taxpayer with the tax administration, which is directly related to the SII mission.

The risk is one of the most important variables in defining strategies for dealing with taxpayers, in control and audits as well as assistance.

Detecting, modeling, measuring and controlling risks are a task that requires important efforts and resources.

**Why do we need to measure and manage risk?**

We do it in order to ensure long term compliance and to optimize resource use in higher risk areas.

**Risk management**

- Risk Management is a formal process where the risk factors, for a particular context, are systematically identified, analyzed, valued, prioritized and attended.
- It is a proactive and systematic analysis of possible events and their answers, more than a mere reaction to these limited detected events. It is the administration of the future.

**Strategic risk management process**

- To establish the context in which the organization operates, its goals, strategic axis, values and culture and setting a framework for risk decisions making.
- To analyze the organization and environment, identifying the present and potential risks, and:

  – Consider the probability of risk occurrence.
  – Consider the level of reliable probability.
  – Consider the level and reliability of monetary exposure

- Valuing and prioritizing the risks: probability of occurrence, exposure level, cost reduction effectiveness, compared to other resources uses.
- Possible actions on risks, such as: to avoid, to reduce, to transfer, to maintain or to accept them.

**Risk valuation in practice**

- They are subjective estimates that must be sufficiently reliable, reasonable for the Tax Authority and that could be justified to the taxpayers.
- The risk identification process cannot be very abstract and complex
- Risks may be categorized under a qualitative ranking system, based on historical data, using data mining techniques, or a mixture of both.
- Once risks are prioritized, the risk treatment strategy (avoid, reduce, transfer, maintain) must be defined and resources applied, determining costs in order to select the most appropriate one.
- A residual risk will always exist.

**Risk valuation by a tax administration**

- Context:
  – To make sure that taxes are paid by those who must do it, for the correct amount and at the correct time.
- Basic Risks:
  – No taxpayer registry; no return; no timely return; no payment.
- Possible causes:
  – Error, ignorance, confusion of requirements, unclear law, economic situation, breaches in the Tax Administration operational processes allowing tax evasion.
  – A high level of tax legal knowledge and assistance are required.
  – The needs of the taxpayers can be detected through a

complex process of assistance and compliance levels can be improved. (Decreasing the noncompliance).

## 3. EVOLUTION OF RISK MANAGEMENT IN THE TAX ADMINISTRATION

**Traditional approach:**

- Control each taxpayer.
- Very expensive.
- Same Treatment

**Intermediate approach:**

- To accept returns.
- To process and review them later.

**Risk-centered approach:**

- Segmentation of taxpayers into various groups and evaluate those with high default risk and the monetary consequences
- Assistance for voluntary compliance to new taxpayers through education and law simplification.
- Techniques to determine noncompliance, using data crossing:
  – Returns vs. external data
  – Returns vs. industrial data, profession, norms.
  – Returns vs. audits and similar industry results.
  – External data vs. external data.
- These techniques require more documentation and a more formal and standardized risk management process.

## 4. Risk management by segments in a tax administration

Each segment presents different risk levels => Different approaches are called for:

- Individuals generally are at risk of submitting incorrect deduction of working or living expenses.
- A subset of them, with high income, could perform complex financial and business arrangements to avoid taxation.
- Increased risk in medium and small enterprises segments, due to poorly developed maintenance and records systems.

1. The segmentation must be applied with flexibility and care, especially when business groups have interest in different segments (a specific risk can affect to more than one segment).

2. The tax authority should know the relative compliance ratios, the tax exposure and responsibility of each segment, for locating resources and ensuring compliance.

3. Without a compliance measurement program, the selection of segments to control becomes subjective:

   - Develop sensitivity to the risks and their relative importance according to valuation risk, focused audits, external business information from certain economic sectors and companies.
   - Perform fast verifications of a limited taxpayers group in a specific segment / industry to obtain a risk level.
   - If a mitigated risk is found, a mix of services, such as strengthening the service and administrative changes in the sub-segment can be used.
   - The result of these activities should be evaluated after a period of time to determine at the risk level that still exists and which strategy was the most successful and less expensive.
   - The risk valuation process should be impartial otherwise incorrect decisions can be taken regarding the location of resources and strategies.
   - Separate the risk valuation function from the application of mitigation activities.

## 5. RISK AREA

The Risk Area has adapted the theoretical methodologies of Data Mining to the institutional reality, in order to generate statistical predictive models (using the term "predictive" for showing that a technique or science has been used, for making conjectures about an unknown fact). This is a process where the requesting unit and / or the one having knowledge of the phenomenon to be studied, beginning with a meeting where the information to use, the potential for solution and their needs are defined. In general, the process includes the following stages (Figure 0 1):

1. Presentation of the modeling proposal.
2. Capturing data to generate modeling variables and target vector.
3. Meeting for Objective Vector agreement.
4. Preprocessing and data transformation.
5. Selection and use of modeling techniques.
6. Determination of patterns.
7. Interpretation and evaluation of the model.
8. Transfer of the results to the affected area.

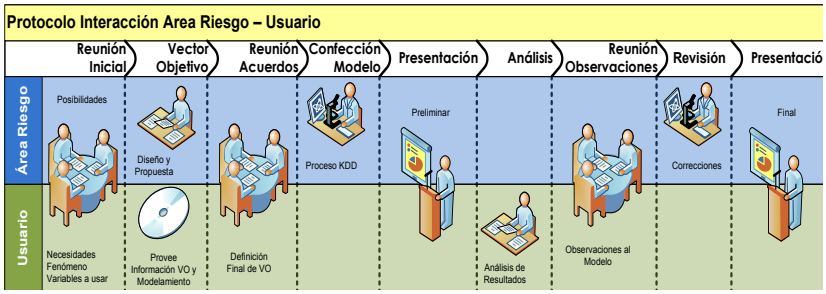



Figure 0-1: review process to establish a risk model.

## 6. ANALYSIS TOOLS

### General models

Estimate models for the general risk, oriented to taxpayer groups segmented by sales size (Large, Medium, Small, Micro Enterprises and Individuals), are called "strategic" because they estimate the probability that a taxpayer does not comply with the correct tax payment. And the use of information extracted from this indicator is not for the selection of taxpayers, but rather to monitor how risk evolves in the taxpayers groups.

To prioritize potential control cases, already selected by a traditional method, overall risk scores, or "strategic" scores are used. For these purposes some algorithms results of "anomalies" are also used.

The risk scores, general or specific, and the "anomalies" can be the income, and another attribute, for building other models that estimate risk.

The risk scores, general or specific, can be used for risks analysis to taxpayer grouped by different criteria; for example the figure shows a matrix of taxpayers by Region (vertical) and Economic Sector (horizontal), and intersections show the average risk score for each group, the most risky ones in red and the least risky ones in green. They can also be used to analyze the risk evolution.

### Specific models

Estimate Models for specific risks: For instance "Use of False Invoices". We call them specific since we design to measure the probability of a particular fact. This example estimate the probability that registered taxpayers report their VAT amounts based on false invoices, either from false operations or from not legalized documents.

The risk scores of specific models are used for selecting taxpayers, since they estimate the "control hypothesis".

The risk scores, general or specific, and the "anomalies" can be the income, and another attribute for the building of other models that estimate risk.

The risk scores, general or specific, can be used for risk analysis, for taxpayer groups segmented by different criteria (Figure 0 2). They can also be used to analyze the risk evolution.

| | Sector Económico | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Región** | Administración Pública | Servicios Financieros | Servicios Personales | Comercio, Restaurantes y Hoteles | Construcción | Transportes | Industria Manufacturera | Agropecuario - Silvícola | Electricidad, Gas y Agua | Minería | Comunicaciones | Pesca | **Promedio** |
| 1 | 0,00 | 0,26 | 0,22 | 0,06 | 0,23 | 0,07 | 0,31 | | 0,00 | 0,40 | 0,18 | 0,18 | 0,1 |
| 13 | 0,28 | 0,10 | 0,15 | 0,20 | 0,25 | 0,16 | 0,27 | 0,37 | 0,22 | 0,20 | 0,28 | 1,00 | 0,1 |
| 15 | 0,04 | 0,15 | 0,15 | 0,22 | 0,21 | 0,17 | 0,26 | 0,32 | 0,28 | 0,31 | 0,32 | 0,45 | 0,1 |
| 9 | 0,00 | 0,19 | 0,37 | 0,13 | 0,21 | 0,15 | 0,30 | 0,30 | 0,47 | 0,45 | 0,69 | | 0,2 |
| 2 | 0,00 | 0,17 | 0,13 | 0,11 | 0,29 | 0,43 | 0,41 | 0,19 | 0,47 | 0,28 | 0,18 | 0,20 | 0,2 |
| 4 | | 0,25 | 0,52 | 0,11 | 0,08 | 0,19 | 0,20 | 0,49 | 0,46 | 0,45 | | 0,67 | 0,2 |
| 8 | 0,00 | 0,19 | 0,28 | 0,19 | 0,25 | 0,23 | 0,35 | 0,37 | 0,49 | 0,53 | 0,19 | 0,45 | 0,2 |
| 14 | 0,22 | 0,22 | 0,15 | 0,24 | 0,28 | 0,30 | 0,28 | 0,35 | 0,29 | 0,43 | 0,61 | 0,70 | 0,2 |
| 5 | 0,00 | 0,26 | 0,31 | 0,19 | 0,24 | 0,30 | 0,30 | 0,40 | 0,38 | 0,22 | | | 0,2 |
| 19 | | 0,29 | 0,23 | 0,09 | 0,23 | 0,20 | 0,30 | 0,45 | 0,33 | | 0,50 | 0,50 | 0,2 |
| 7 | | 0,18 | 0,35 | 0,22 | 0,33 | 0,26 | 0,31 | 0,40 | 0,40 | 0,47 | | 1,00 | 0,2 |
| 3 | | 0,21 | 0,24 | 0,19 | 0,36 | 0,22 | 0,13 | 0,39 | 0,21 | 0,53 | 0,44 | 0,40 | 0,3 |
| 12 | 0,00 | 0,19 | 0,17 | 0,20 | 0,52 | 0,27 | 0,52 | 0,44 | 0,21 | 0,51 | 0,75 | 0,65 | 0,3 |
| 17 | 0,53 | 0,57 | 0,53 | 0,50 | 0,58 | 0,46 | 0,64 | 0,63 | 0,60 | 0,72 | 0,69 | 0,78 | 0,5 |

Figure 0 2: taxpayers matrix by region (vertical axis) and Economic Sector (horizontal), at intersections is the average risk score for each group, the most risky in red and the less risky in in green.

### Anomalies

The "Anomalies" are algorithms used to determine odd behavior from of a business or tax point of view, which not necessarily means noncompliance. For example, taxpayers who do not submit their monthly returns but keep requesting the legalization of tax documents.

To prioritize potential audit already selected by traditional methods, overall risk scores or "strategic" risk scores are used, as well as some results from of "anomalies" algorithms.

The risk scores, general or specific, and the "anomalies" can be the income, and another attribute for building other methods that estimate risks.

**Measurement methodologies**

Measurement methodology is associated with the development of an observation method for auditing the taxpayers' future behaviors. This method uses as a comparison basis the past behavior of the taxpayer or with his segment or sector, among other analysis relevant for control purposes.

## 7. THE FUTURE

**Quality of information evaluation**

The tax administrations work is based primarily on managing accounting, economic and financial information of taxpayers, so the quality of the information that enters the various analytical processes is essential; and additional measure in this sense is the design of a methodology, using statistical criteria, that will estimate the quality of the information entered in our databases, and to define strategies and actions that improve the data quality.

**Text mining**

The Risk Area team is preparing to enter a new dimension of analysis information, in this case unstructured data, acquiring a text mining tool, and training in techniques to usefully exploit this type of analysis. The text mining methodology allows performing analysis of open texts containing accounting, economic and financial information from taxpayers, for example the product description on invoices and financial reports, information from web pages and other publications, etc. In short, there are many possibilities.

**Web Mining**

In view of the current challenges and due to changes in the way we do business, it is essential to strengthen our business intelligence service with information collection actions and monitoring on the Web, in regard to activities associated with taxpayers, industrial sectors, products or services, in which potential commercial transactions are detected related to the marketing of products or services, that given the current forms of control, need specific tools for this purpose

## II. SOFTWARE FOR AUDITS

### 1. BACKGROUND

When officials perform a tax audit process, documents verification, and VAT refunds, among others, in addition to performing the control, they must spend time for the administration and registration of the case development.

In this area, a few years ago the Internal Revenue Service did not have a tool that would allow tracking the development of a tax audit, and also solve control process management, as well as having an automatic registry of events associated with tax audits made to taxpayers.

The purpose of a tax audit is to verify the taxpayers' compliance. Therefore, tax returns correspond to the accounted operations according to their commercial value, to the tax and accounting support documentation, and reflect all transactions or operations performed.

First, audits are assigned and monthly distributed to officials of each office in the country. This procedure used to be performed through email or paper. Thus, during the control process which took place in offices, generated the required documents to be delivered to the taxpayer through notification; which the taxpayer had to review in order to clarify certain differences on taxes. The documentation submitted included the payments for the settlement. The TA requested a payment of the tax differences detected. Among the actions from an audit, the possibility that the taxpayer acknowledges the tax differences and correct his statements was also considered, it was also feasible that the taxpayer fully clarify the information provided, thus ending the control. In any case, during the tax audit, the documentation provided or removed by the taxpayer was registered, using documental receipts or returns.

To complete each of the above mentioned forms, the auditor had to enter in the applications the information required to perform the actions (name / business name, address, legal representatives, and others specific taxpayer data). In each of these actions, a number of subtasks were identified; recording every event in the audit, but these tasks increased the workload in each of the cases under examination.

Certainly, one of the complex instances within the audit consists in establishing the legal background that underlies the tax differences determined in the audit. Such legal grounds play a key role in those cases in which the taxpayer makes use of his rights under the tax law,

particularly when he appeals against actions taken during the audit, to the tax Courts, which currently operate autonomously.

As a result, the control process resulted in a set of worksheets available to auditors, both for the internal audits and for the taxpayer registries, which eventually turned into case folders. In addition, during audits, manual notes were taken for the Tax Administration, reporting the taxpayer's situation, which in some cases allowed controlling the business operations, through denying the legalization of tax documents.

It should be mentioned that when taking these notes it was always possible to make an error in the procedure error, and the appropriate entries regarding the taxpayer noncompliance were not always entered in the systems.

The method used to solve this problem was the implementation of a tool based on information technology that would monitor the workflow related to the audit performed to taxpayers, in this sense, building such tool provides the necessary support to officials for their specific audit tasks.

Indeed, the completion of this project allowed facilitating and supporting the audit by the tax officials, for standardizing these actions, and having permanent, accurate and timely information related to the management of national and regional tax audit.

## 2. DEFINITION

The Support Audits System (SADA) is a technology platform that manages the entire business flow of tax audit.

This platform includes tools that enable the Business Process Management (BPM), in which all workflows associated with an audit are managed.

Therefore, the platform integrates processes modeled, with web services that provide the internal information to the institution regarding the taxpayer, thereby increasing the information available to officials, the value of the information technology infrastructure and optimizing the use of the workforce.

This working environment also facilitates and supports the documentation of the activities developed in the control process.

## 3. GENERAL OBJECTIVE

Implementing SADA nationwide intends to standardize the procedure to carry out a tax audit, providing the officer with a software tool and a work environment in order to facilitate the monitoring and the generation of audit tasks.

## 4. SPECIFIC OBJECTIVES

Implementing the system:

- Facilitate monitoring and management control processes from the Program Registration until the financial transfer, allowing the generation of information for the workload management and administration.
- Facilitate standardization in execution and registration of actions performed by the Service through management and generation of various tax audit processes
- Keep an automatic record of cases history (as the officer develops the case using the tool), which will allow to have accurate and timely case management information.

## 5. PRODUCT CHARACTERISTICS

The project included the development of the following features:

- Registration of control programs: Allow registering programs designed for control areas, including their objectives, taxes, taxpayers, periods and documents under review, and any relevant information within the programs.
- Case entry, selective and emerging case assignment control: It is the control and monitoring of the cases that are included in centralized audit plans.
- Entry of emergent cases: It is the control and monitoring of cases arising out of the plans, which are generated by a same unit. They allow making a special plan for the case to be analyzed as well as the assignment of an inspector responsible for the audit, and follow the other audits procedures.
- Audits Follow-up: Include the whole process of taxpayers audit (Notifications, Citations, Settlements, etc.), according to the plans provisions, allowing to keep track of all the activities and tasks involved. This module incorporates the history of taxpayers not required and requested, open actions such as notification, settlement, provisional settlement, reassessment, return of documents and registry of the case conclusion.
- Entry and follow up of refunds: Allow registering the taxpayer's request for refund and the result of this request, generating legal documents, automatic or manual resolution depending on the type of tax. Here the VAT refunds for purchases of fixed assets (27 bis) are registered and VAT for subject change.

- Monitoring of document verification: allows recording the documents to review, entering the verifications for each case and the results of this process, allowing repository of verified documents. It also provides information on the revised documents.
- Reports: allows an overview of the tax audits assigned to an office, so the management can take decisions regarding their development.

## 6. SADA AUDIT WORKFLOW

The process begins with the entry of the centralized cases load, and their automatic distribution to each of the country units (Plan); the SADA automatically captures information from other Tax Administration applications. The units can autonomously enter cases (emerging) to monitor, if they could represent tax evasion schemes.

Next, the workflow starts generating the corresponding tasks, so that officials can proceed to the specific actions (Case Notification, Rectification, Citation, Settlement, and Case Termination). Thus, with the information entered into each of the screens that compose each action, the system will automatically generate the necessary documents to communicate formally with the taxpayers; it should be noted that these documents have replaced the paper forms previously associated with each stage, which were issued independently by each service office; this has facilitated the standardization of procedures at country level (Figure 0 3). It should be noted that the process of verification of documents and request for refunds are actions controlled by the tax authorities on certain operations of the taxpayer, and could constitute an audit.

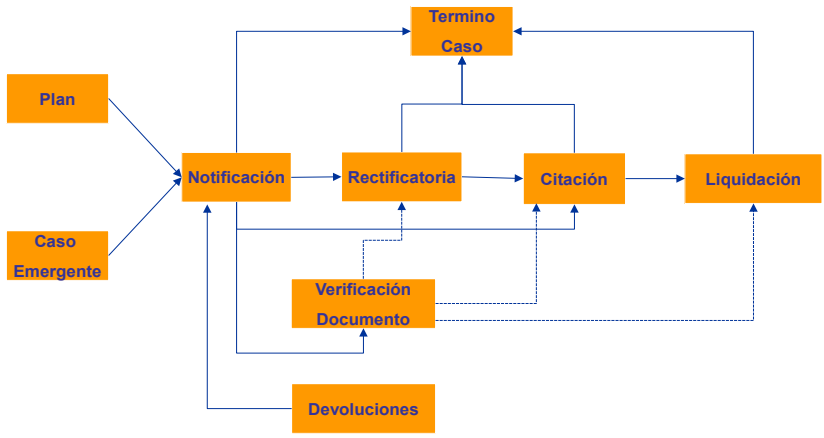



Figure 0-2: SADA Audit flow chart.

The workflow allows, for each stage, to generate and automatically upload information through Web services for the tax administration database. This keeps updated the information related to each taxpayer control, and the notes that previously were done manually are now automatically loaded in the corresponding internal systems. Similarly, the system collects the taxpayer information from other systems and databases to generate actions, related primarily to the taxpayer's own information, tax behavior, and forms submission, among others. Officials do not have to access the systems to update this information; this reduces the time spent in auditing for completing repetitive tasks, minimizing control process time.

In order to facilitate the officers work in the control process and to ensure a better legal basis for each of the tax differences detected from the tax audit, it is to note that instructions associated with the use of the system highlight the importance of standardizing the various figures of tax evasion; in this sense, the system provides the officer with a basic structure for each one of the detected differences, through the selection of the legal framework needed to explain and support these differences.

## 7. BENEFITS

**For auditors**

- **Simplification of the daily control work, by accessing automatic information from other applications (taxpayers' registry, monthly and annual tax forms):** Via web services, the application communicates with other internal systems which have the necessary information to create the control documentation; this allow determining the amounts the taxpayer has to pay.

- **To report pending cases and their history*:*** The program includes an user menu which allows clarifying the pending tasks for audit, and store the information, which can be consulted at any time.

- **To allow the creation and registry of the performed actions:** The system allow saving the information entered for any action, and also generating the document which represent the action requested by the controller (certificates of settlement, notices, summons, assessments, reassessments and provisional assessments).

**For authorities (Group, Department and regional Director)**

- **To have a system that supports the administration of cases and tasks**: The system enters the cases that are distributed to the units, and through the workflow, assign them to the auditors in charge, which allows for clarity of the workload in each unit.

- **To be informed on the development and outcome of the cases**: The system has modules for consultations according to the profiles. This allows access to each case parameters; for the cases that are completed, it is possible to know the associated yields, and for pending cases to view the tasks already carried out.

- **To standardize performance reports:** The workflow creates tasks within a performance (notices, summons, settlements, etc.) Through a logical order, structuring the way the review process is done, ensuring the quality of the action.

- **Reporting:** The system allows exporting data to other formats and generating reports with the information that the user requires.

**For the national audit management**

- **Time optimization in the control process:** The automatized system allows a better efficiency and better use of the controllers' time for control activities, most of all because the review deadlines are regulated.

- **Standardization of the quality of the settlement:** The legal support provided by the application, through a justification of the detected differences allows backing the observations transmitted to the taxpayer. In case of appeal to administrative courts, this allows a better follow-up and control.

- **Reliable information is available online:** Allow timely information about the tax control actions registered in the application:

  – Workload information.
  – Cases yields.
  – Cases history registry.

- **Feedback in control processes:** The system allows determining the controls yields, and associated concepts, redefining the control programs or creating new ones in cases where it is necessary if important elements of the case were not mentioned

- **Standardization:** This allows that the processes involved in the audit are carried out homogeneously throughout the tax administration, independently of the particularities that may exist in each office.

- **Integration with other applications:** The option to integrate SADA with other internal applications not only allow transferring information from one system to another, but also allow the complete result of the audit, including what the taxpayer has transferred, and what was entered in the treasury.

## 8. RESULTS

The use of SADA began nationally in 2012. For this period, the amount collected from audits by the Internal Revenue Service was $ 1.356 billion, which is obtained from Selective, Emerging and Massive Examination actions. By breaking the previous figure into selective and emerging control concept, the total registered cases in the system is approx. 5,800, with a yield of $ 735 thousand million (Table 0 1).

| | Amount of cases audited | Revenue collected (MM$) |
|---|---|---|
| Selective audits | 3.664 | 634.421 |
| Emerging audits | 2.188 | 101.310 |
| **TOTAL** | **5.852** | 735.731 |

Table 0-1: cases audited and revenue obtained via SADA application in 2012; the performance of these cases represents 54% of total revenue from control.

## 9. CONCLUSION

The Audit Support System (SADA) is a management tool that has allowed enhancing the control process. It is the application where all audits independently from their origin will be developed, since its main advantage is to standardize the process, along with retaining all information related to the cases, which is useful when generating reports to show the case status, performance, development time, among others; it also contributes to resource management, as well as to measure the efficiency and effectiveness of the audit work. The SADA is a flexible application, making possible to implement new tax arrangements applying a continuous improvement in the audit process.

Through the use of this tool, the audit manual process is replaced by an automatic one, which eliminates errors inherent to manual repetitive tasks. It should be noted that the analysis of each case by an officer during audits remains the most important raw material in the process, so the tool only intends to help carrying out all the associated tasks.

*Case Study*

*Topic 1.2*

# RISKS ANALYSIS AND AUDIT SOFTWARE TOOLS (DATA MINING)

**Martine Meunier**
Head of the Interregional Tax Audit Directorate
General Directorate of Public Finances
(France)

***Contents:*** *Abstact. 1. The legal framework. 2. The tools and administrative organization. Conclusion / Perspectives*

## Abstract

Almost all companies' accounts are held today using accounting software. The term 'computerized accounting control' covers two totally separate procedures, implemented currently in France under the framework of accounting audits.

The first offers the possibility for companies to communicate their accounting files, and the reading of these data takes place using a specific tool locally designed.

This tool offers a real advantage in terms of organization flexibility and completeness of controls, and is intended to be used by all auditors because it does not require very sharp computer skills.

The French legislative framework for the control of the computerized accounting has been renewed in the end of 2012.

From 2014, it becomes mandatory by law for all companies holding a computerized accounting, to submit accounting documents in digital format defined by the Decree. This highly anticipated measure will allow the general use of this tool, which is now only used in 40% of the controls performed in the DIRCOFI Auditors.

The second procedure refers to the companies' obligation to perform the data processing upon request by control services or allow the authority to perform these processes.

The administration often uses the ACL audit tool, particularly for the controls of medium and large enterprises under the DIRCOFI and DVNI Jurisdiction.

The use of ACL is not easy, requires regular practice and may be only achieved by a limited number of specialists who support their other colleagues. In this regard, a comparative study reveals that several countries have made the choice to train specialists in computerized accountings to support the General Auditors. The ACL procedure is used in France in 3% of the external controls. It significantly slower the field operations, increasing by 90% the average time in DIRCOFI. However, for these cases, the ACL tool is characterized by a better financial performance, and the median net income provided by these cases is exceeding by more than 45% at the median of the total net revenues found in DIRCOFI.

**DIRCOFI**: direction of fiscal control
**DVNI:** direction of national and international audits

Accounting is currently usually held through accounting software, for this reason the auditors perform controls using new tools in the existing legal framework.

In France, a specific legislation is applicable to the computerized accounting control.

## 1. The legal framework

The current legislative framework offers companies the option, but not the obligation, to submit their accounting through an electronic copy of the accounting files.

This option becomes mandatory from January 1, 2014.

Computerized data refers only to accounting entries, and not to the supporting documentation.

The taxpayer can copy the files on a CD-ROM or enable the auditor to make a copy on an external device. This delivery is registered on a document submitted by the auditor and signed by the taxpayer.

This measure must allow and facilitate the accounting control by the auditor and verify the consistency between the returns and the accounting files, reducing the auditor’s time in the company.

The operations performed by the auditor on copied files are limited to procedures such as sorting, rankings and simple calculations. In this regard, they cannot process all types of data.

Legislation allows control services to process data, allowing the taxpayer to choose between three types of treatment:

Data processing performed by the administration at the enterprise, on material available by the taxpayer:
In this case, the taxpayer must take all appropriate measures to preserve the data and the safety of the equipment used. Information, data, processes and documentation must be available to the administration in order to allow the investigations under normal conditions.

**Data processing performed by the taxpayer for all or part of the requested data to control**:

If the company chooses this option, the officers responsible for the audit must indicate in writing what elements they want to control (specification) and the period requested for its implementation, which must be compatible with the constraints inherent to the business operation, on a document also signed by the company's representative.

The results of the control request must be delivered in digital format according to specific criteria. The administration acknowledges receipt of the results submitted by the taxpayer, and reserve the right to approve their compliance with the request.

- **Data processing performed by the administration, out of the business premises, after submission of the computer files by the taxpayer**:

The taxpayer provides the auditor, with computerized copies of all documents, data and processes needed to perform the audit. They include a description of the management information (name of areas, heading...) and technical information (type, structure, position, length of the zones, fonts ...).

If a tax adjustment arises from the performed controls, the auditor informs the taxpayer about the nature and results of the data processing which gave rise to the adjustment at the latest when sending the settlement proposal.

## 2. The tools and administrative organization

This computerized accounting approach is different in France according to the types of companies and their control level.

There are three control levels according to the geographical location and the sales volume (turnover).

At the national level, the DVNI controls the large international companies with the support of BVCI (specialized computer control units) with auditors specialized in computerized accounting assistance.

At the regional level, specialized auditors are trained in the use of the ACL tool.

At the local level, auditors often use excel software for data processing.

Interventions by computer experts can be performed from one structure to the other.

The general auditor can read the general accounting with a tool enabling simple filters for balancing accounts.

This tool is an accounting reading software, which has been designed to meet the needs of auditors with no specialized knowledge in information technology.
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It facilitates the accounting operation and the reconstruction of the processes chain between the data entry and the tax documents issuance, allows structuring investigations and facilitates the tracking of ledger entries and reversals.

For example, pre-filled or customizable queries are used to detect reverse entries, interruption in number sequences, etc.

More complex treatments with Excel or ACL tools may be performed by the auditor alone or with the assistance of a specialized colleague.

Finally, for large companies, the audit is always specialized and performed with the help of the BVCI or ACL experts.

**Computerized control objectives**

The computerized control has several objectives:

- efficiency:

It saves time for the auditor to perform specific accounting balancing (audit process).

- comprehensive

Without a tool, it is impossible to review all the data of important business volumes (ex: provisions, purchases invoices...).

- The increased quality of adjustments is sustainable at litigation and criminal levels.

**Common investigations issues**

- Revenues dissimulation:

All activities with significant cash flow are verified to detect inconsistencies in the cash flow data system.

- Diversion of goods:

Stocks existences are verified for medium size companies with a computerized inventory management.

- VAT rates:

It applies to all activities with multiple VAT rates.

- Transfer pricing:

The margins by customer and product are analyzed for all activities and separate results accounts by activity are restored.

- Provision on inventory:

All activities with a provision for a minimum of 1 million euros are verified through a statistical analysis.

The computerized control is also used for programming purposes, for example by recovering the client file of a wholesaler to identify customers paying in cash.

**Implementation difficulties**

The procedure to perform the data processing (see above) is complex, and the technical complexity is increased due the fact that the French legislation does not provide a standard audit file.

The stage of data formatting is heavy and requires strong computer skills. This is a significant barrier to the development of computerized controls.

Finally, the importance of the so-called permissive accounting software used in France should be noted. They have a module allowing the user to modify the accounting data while preserving as much as possible their coherence. Today, this feature for modifying accounting data is often external to the 'official' accounting software, which increases the difficulty for control.

This type of fraud requires heavy resources to enable their detection and provide evidence to identify their author. The use of heavy procedures (field search) is necessary.

**Conclusion / Perspectives**

The notion of 'computerized accounting control' at the DIRCOFI frequently refers to the simple reading of the digital accounting through a local tool, sometimes complemented with a few simple operations of sorting or calculating, and not to the implementation of complex data processing, which involve not only accounting elements, but also management files, which constitute the real computerized accounting control.

*Case Study*

*Topic 1.2*

# RISK ANALYSIS AND AUDIT SOFTWARE TOOLS (DATA MINING)

**Dino Iliopoulos**
National Manager
Large Business Programs
Canada Revenue Agency
(Canada)

***Contents:*** *1. Introduction. 2. Current environment at the CRA. 3. The risk assessment process. 4. SARAT. 5. Experiences to date. 6. Future plans. Conclusion.*

*Presentation PPT*

## 1. INTRODUCTION

Over the past four years, the Canada Revenue Agency (CRA) has been involved in a business transformation process that includes a shift in focus to a risk-based approach to compliance activities.

In September 2010, CRA launched its new Approach to Large Business Compliance (ALBC). ALBC represents a significant change in the way the CRA manages income tax compliance in the large business sector, and will fundamentally change the CRA's risk assessment process, its interaction with large business taxpayers and their tax intermediaries, and the use of audit resources.

This shift in approach is in response to, inter alia, the challenges of increased aggressive tax planning, globalization and its impact on international tax competition and the need to ensure finite CRA resources are devoted to the highest priorities.

Within the scope are all taxpayers with over CAD$ 250 million annual revenues (over 1,100 economic entities and related parties, totaling over 26,000 corporations), as well as any structure (including trusts and partnerships) for which the Large Business team audit approach would be most effective.

ALBC requires a shift in taxpayer expectations (as taxpayers begin to believe that audit extent and scope will decrease for lower-risk files), in auditor mentality (to view cooperative taxpayers differently than non-cooperative ones) and in CRA resource allocation and utilization (as regional audit program resources may not be aligned geographically with risk distribution). The approach is in line with recommendations from recent OECD work including the 2008 Study on the Role of Tax Intermediaries.

The purpose of this paper is to share the experiences the Large Business Audit Program has gained from the transition to this risk-based compliance approach and discuss the audit software tools employed in this regard.

## 2. CURRENT ENVIRONMENT AT THE CRA

The mission of the CRA is to administer tax, benefits, and related programs, and to ensure compliance on behalf of governments across Canada, thereby contributing to the ongoing economic and social well-being of Canadians.

Under Canada's federalism model, the country is divided into ten provinces and three territories with each having its own provincial/ territorial government. As Canada's national revenue collection agency, the CRA collects tax revenues and administers social benefits on behalf of provinces and territories under formal arrangements with the federal government.

Canada collects taxes through a self-assessment system. This system is based mainly on voluntary compliance, which in turn is based on mutual responsibility. Individuals, corporations, and trusts that are obliged to pay tax in Canada are expected to meet their responsibilities under the law.

The CRA has a responsibility to maintain public confidence in the fairness and integrity of the tax system. This means providing ample support to those who wish to comply with the law, while taking appropriate measures to identify and deal with cases of non-compliance.

For administrative purposes, the CRA has established five regions across Canada. Each region has a high level of social and economic consistency that provides an effective basis for program planning and delivery. For example, the four east coast provinces that make up our Atlantic Region are characterized by a strong relationship to the sea. Fishing occupies a central economic and cultural role in this region.

Other industries such as forestry, tourism and, more recently, offshore oil and gas exploration are also important to the regional economy.

The CRA uses a functional model to plan, budget, manage, and monitor its program activities. Under this model, priorities, performance expectations and budgets are first determined for each of the Agency's branches. Each Branch in turn establishes the priorities, performance expectations and budget for each Region and the Regions then allocate work and budgets to their respective offices to deliver the programs and services according to the priorities and objectives that are established.

This cascading of management direction establishes a clear line of sight for management accountability and a common understanding throughout each program of what is important and what is to be achieved.

The CRA's compliance activities help to preserve public confidence in the fairness and integrity of the tax system. The vast majority of compliance activities undertaken by the CRA are the responsibility of the Compliance Programs Branch (CPB).

Within CPB, there are six directorates responsible for ensuring compliance with three key revenue sources: income taxes, excise taxes and duties, and the Goods and Services Tax/Harmonized Sales Tax (GST/HST).

The International and Large Business Directorate (ILBD), includes the Large Business Audit Division (LBAD), which is responsible for addressing non-compliance issues by large businesses, analyzing large business audit results, developing and publishing strategic policies for large businesses and providing guidance and support to staff engaged in the audit of large businesses.

## 3. THE RISK ASSESSMENT PROCESS

Prior to 2010, the CRA's Large Business audit program operated under a full coverage system. This meant that all taxpayers in the Large Business population were audited on a three year cycle, regardless of risk levels. However, with increased demands on CRA resources, this audit approach was unsustainable.

In 2009, the CRA changed focus away from a full coverage audit approach to a two-tier risk-based audit approach for the Large Business population.

**Tier I risk assessment**

The first step in the risk assessment process involves a cursory review of the every large business, which takes into account taxpayers' and tax intermediaries' compliance risks, corporate governance and history of compliance behavior.

Under this process, the Large Business entities are subject to ongoing evaluation in terms of their risk of non-compliance and segmentation into High, Medium or Low risk categories using the National Risk Assessment Model (NRAM) to document the results.

There is a tailored compliance approach for each risk segment:

- High Risk Taxpayers – subject to a full scope audit
- Medium Risk Taxpayers – subject to an issue-based audit
- Low Risk Taxpayers – subject to a compliance assurance review

This segmentation of the Large Business population allows for increased efficiency and effectiveness in the audit cycle by ensuring that taxpayers are selected for audit based on CPB priorities. All taxpayers in the Large Business population are risk assessed, using the NRAM, on a yearly basis.

Given the prominence of risk and the impact of risk rating on the workload selection process, the CRA has established a NRAM Calibration Committee comprised of senior representatives from ILBD in Headquarters as well as the Regions. The main purpose of this committee is to provide advice and recommendations with respect to quality and national consistency of NRAM risk assessment ratings. The committee plays a significant role in CRA's risk assessment and workload development initiatives.

**Tier II risk assessment**

Once a decision has been made to undertake an audit, it is assigned to a Large File Case Manager (LFCM) in a CRA Tax Services Office (TSO), who then carries out the Tier II risk assessment exercise with his/her team of specialty auditors from CPB's International Tax and Aggressive Tax Planning Divisions.

This step involves a thorough analysis and documentation of the significant risk issues that form part of the audit plan. This is done with the use of the Standard Audit Risk Assessment Template (SARAT).

## 4. SARAT

The SARAT is a complex and comprehensive application program developed by the CRA in 2008 using Microsoft Excel.

SARAT is designed to provide a quick and easy way for the Large File Case Managers and auditors to assess and document the risks in the audit. It also provides a means to help develop a comprehensive audit plan by streamlining the information thorough the following three stages:

- Stage I – Information Gathering and Analysis
- Stage II – Issue Selection and Prioritization
- Stage III – Detailed Audit Plan and Audit Execution

SARAT's graphical, navigational and macro tools simplify interaction with risk issues in each stage. The auditor can process one principle file and up to four secondary files in the same document at one time.

SARAT contains many hands-on quick links, which facilitates access to various internet resources to help assess the specific risks, while the built-in macro applications in the SARAT allows the collection of data created by the application program.

Overall, the SARAT can be viewed as providing two key functions in the Tier II risk assessment process.

First, it provides the LFCM a detailed (but non-exhaustive) list of factors that should be considered when risk assessing the business.

Second, it helps document the findings and considerations identified by the LFCM and his/her team of specialty auditors. This aids in the preparation of an audit plan that focuses solely on the identified risk areas of non-compliance.

While populating the SARAT with the required information is labour intensive, it plays an essential role in focusing our compliance efforts, making our audits more effective, and documenting risk assessment and review procedures.

Since its development, the SARAT became a mandatory process in the 2008-2009 fiscal years and has received numerous upgrades and revisions since.

## 5. EXPERIENCES TO DATE

In addition to segmenting the Large Business population into High, Medium and Low risk taxpayers, the CRA's ALBC has also led to the introduction of face-to-face meetings with senior management within each Large Business economic entity. During these meetings, the CRA informs the taxpayer of their risk rating and discusses the reasoning for the ranking. To date, almost 25% of the Large Business population has had these meetings and the feedback has been very positive.

The taxpayers appreciate the transparency that CRA is showing and in knowing the reasons behind their rating so that they can take steps to reduce their rating and potential audit exposure in future years.

It is anticipated that over the next several years, the CRA will have held these face-to-face meetings with all taxpayers in the Large Business population. After that point, we will be in a position in to evaluate the effectiveness of the ALBC including the risk assessment process, allowing for any revisions to be made to reflect the current environment.

## 6. FUTURE PLANS

LBAD is working closely with CPB's Business Intelligence Risk Management Division to complement the existing NRAM (Tier I) process with a system that will enable LBAD to automatically rank the Large Business population based on the perceived occurrence of non-compliance.

This will enable a more effective risk assessment segmentation and aid in the development of a national workload. Building on the progress in calibrating NRAM and enhancing the risk assessment factors, the CRA will create a national workload development framework.

This framework will enable the CRA to prioritize its Large Business audit workload on a national basis and optimize the allocation of resources based on risk, work plans and technical capacity.

The national workload development framework will compare risk rankings with the national and regional work plans to ensure CRA resources are allocated to the highest priority workload.

The use of SARAT will remain an integral and mandatory process throughout this transition with no anticipated changes other than periodic maintenance and updates.

## 7. CONCLUSION

With the increasing challenges facing auditors and the limited resources available for each compliance activity, it is important for the CRA to focus its efforts on the highest priority issues.

With our change in focus to a two-tier risk assessment strategy, and our use of the NRAM and SARAT, the CRA has established an excellent framework to risk assesses and to identify and document these high risk issues.

This will enable CRA auditor's to continually assess whether the benefit of continuing the audit outweighs the cost. When material risk has been addressed, an auditor should close the file and pursue higher risk files.

In summary, the initiatives and tools described in this paper help CRA auditor's better focus on the highest risk files, work with taxpayers and their representatives to resolve issues at the audit stage and assess the costs and benefits of continuing audits.

*Case Study*

*Topic 1.3*

# CONTROL OF ELECTRONIC COMMERCE

**Giampiero Ianni**
Head of International Cooperation Office
Guardia di Finance
(Italy)

***Contents:*** *Introduction. 1. Regulatory framework**.** 2. Activity of the Guardia di Finanza. 3. Tax audit of a company active as an on-line market platform. 4. Project activity devised by the special revenue unit.*

*Presentation PPT*

## INTRODUCTION

To fully address the issue, however, it is necessary to preliminarily define the concept of e-commerce with which we intend the activity of carrying out commercial transactions online and off-line, such as: selling goods and providing services, distribute digital content, making financial transactions and other. Under this definition are included, both "indirect" and "direct" e-commerce.

In the first case, the preliminary steps of ordering the goods and possibly also paying them are made through the web. The delivery, however, is off-line and the goods physically reaches the domicile or place of business through traditional distribution channels (eg, carrier, mail etc..).

In the second case, however, the delivery of digital contents online is immaterial: the distribution, in fact, is independent from both a physical presence on the territory of the facilities that production-distribution-commercial thereof. In this case, the good is in digital format, such as a software or a piece of music, and thus can be transmitted directly through the internet and the web site structure is a kind of virtual shopping. Internet and e-commerce favour, in fact, immaterial mode of production of income, which are characterized by the absence of formal territorial boundaries.

## 1. REGULATORY FRAMEWORK

Considering that the power of the State to tax its taxpayers is limited only by its territorial extension, it is extremely necessary to adopt a new perspective to deal with phenomena such as e-commerce.

First of all I want to briefly introduce the Italian regulatory framework which, of course, is affected by the international leading position.

In particular, since the Ottawa Conference, the aspects related to tax had as a benchmark the fact that, apart from the use of traditional principles and regulations established to regulate the sector of the e-commerce, tax rules should not be a barrier to the development of the sector, but must be adapted to the economic and commercial reasons underlying the sector of e-commerce, helping the market to provide fair treatment to all forms of electronic commerce by anyone and from any other States.

E-commerce allows, therefore, to operate, apart from those typical elements, such as good sold and place of activity, which, in traditional commerce, allow you to connect an income to its given territory. In online transactions is, therefore, difficult to identify the "territoriality" of the seller and the buyer, and even the place of consumption of the good. To fill this "gap", it should therefore important to identify some specific priorities, such as:

- exactly determine the tax residence of the parties engaged in electronic commerce. In this regard, this place is the one of effective management;
- locate the server.

The server will be important, in particular, where:

- does not merely auxiliary and preparatory activities for the company (such as data collection, information service, advertising, etc.), but the main functions, related to the business of the company;
- remains for a sufficient period of time in a certain place. The server, after all, is obliged to have a physical location register, and, therefore, may represent a fixed place of business.

Waiting for the implementation of the Action Plan on Base Erosion and Profit Shifting launched by the OECD on July 19, the OECD Commentary, on one hand, excludes the configurability of a permanent establishment for the sole reason that a web site has been created by a company in a particular country; in parallel, considers possible

to configure a permanent establishment if the company has located a server within the territory (of a different state than the one where the company is settled) where intended to perform, in a systematic way, functions related to the business of the company itself (and not, therefore, mere preparatory or auxiliary activities). The server, in fact, in certain circumstances can configure a fixed place of business. This happens, as mentioned earlier, if the same server is used by the non-resident company, for the development of its operations or it is fully available to the same foreign entity, regardless of the legal evidence of ownership, which still remains in a specific place for a time long enough to make it comparable to a fixed business base. Also according to the interpretation of the OECD, the provider – the one who manages the server on behalf of other subjects - can be permanent establishment if it could be qualifies as a subsidiary.

The Italian legislation, retracing in substance the position of the OECD, has determined that it is not by itself stable organization the availability, for any reason, of computers and related IT equipment which allow the collection and transmission of data and information relating to sales of goods and services, considering such activity as preparatory and auxiliary.

The implementation of these activities oblige the service provider to register in a Member State of the European Union. In fact, the direct identification in e-commerce, is reserved to operators established outside the territory of the European Union, which carries out the operations of "direct e - commerce" within the EU and in relation to private consumers.

For operator established outside the territory of the European Union we mean a taxable subject (non-EU) which hasn't established place of business or a permanent establishment in the territory of a Member State of the European Union.

In order to carry out such identification, the non-EU operator must submit a "beginning declaration", which provides information on the:

- name or business name and postal address;
- electronic addresses (including websites);
- tax identification number of the State where the company is registered (if any).

The declaration must be accompanied by a self-certification, with which the operator who requires identification in Italy certifies that it is not already identified for VAT purposes in another Member State of the European Union.

In order to fulfil accounting requirements the non – EU operator is requested to:

- keep stored for ten years documents and computer data relating to transactions within the Community and commit to make possible the control on them by the Tax Administrations of every EU country;
- certify by invoice, charged with the ordinary VAT rate provided for the State of residence of the private consumer;
- submit a quarterly statement, by the 20th of the month following each calendar quarter, which contains an indication of the amount of taxable transactions in the quarter, the rate and the tax levied by final consumers of the European Union, with reference to each Member State;
- pay to the State where is identified the total amount of the collected in the quarter.
  – It will be the country that has collected the total amount to share with the others Member States the tax due to them, as well as communicate the data of the relevant tax declaration.

The Italian legislation also disposes the appointment of the tax representative if the non-resident person has not recorded directly and makes the supplies in Italy to individuals or entities not subject to tax.

With reference to the need to "adapt" the tax law to the economic needs of electronic commerce, suggested by the outcomes of the Ottawa Conference, it should be noted that even before the enactment of the Dir. 2002/38/EC, the national legislation has established simplified accounting obligations for e-commerce transactions relating to goods or services regulated by the intervention of financial intermediaries, with particular reference to the simplification of the documentation requirements was also previewed that could be not necessary to issue the invoice in the presence of appropriate documentation.

In the event that, through the Internet, are carried out supplies of goods (eg books, DVD) to private individuals resident in the national territory, the transaction is comparable to a sale by mail or at a distance, for which it has already been provided a suitable set of rules, with exemption from the obligation of billing.

Outside of the domestic market, for various reasons, remains the obligation of billing the transactions occurred.

As an alternative to certification, it can be prepared a transport document with the value indicated, which can also be sent electronically.

Otherwise, however, with regard to transactions conducted entirely in the net (eg. selling digital products such as software or music "downloadable" from the net) in favour of private residents them are considered services territorially relevant to the place of consumption and exists, however, the obligation to certificate the payment by receipt, as the case is not in the list of those exempted from this requirement.

The operational experience of the GdF on e-commerce has shown that people who have used electronic platforms to sale are, often, sole trader or legal representatives of companies whose economic activity registered is not always related with electronic commerce and, indeed, regards sectors totally different from the items offered for sale on the above electronic platforms.

In these cases runs to help the so-called "principle of attraction", according to which the total income of companies and commercial entities subject to IRES (Corporate Income Tax) which have as their exclusive or main purpose the exercise of business activities, from whatever source it comes from, is considered business income.

In summary, this principle is based on a formal criterion: the mere fact that you have a company or a business entity, any income generated are attracted in business enterprises.

## 2. ACTIVITY OF THE GUARDIA DI FINANZA

This brief regulatory excursus was necessary to outline the framework within which our administration carries out its operations. In fact, as early as the year 2000, the Minister of Economy and Finance issued a directive recognizing that the exponential growth of trade via the internet has made urgent the need to check the correct performance of tax obligations by operators in this sector and for this purpose has provided the strengthening of the control activity, by giving to the Guardia di Finanza the task of taking appropriate initiatives aimed at identifying the tax evasion phenomena in the specific sector.

Continuing my brief intervention I am going to present two different activities carried out recently by the Guardia di Finanza in the field of e-commerce:

- the first is related to a tax audit operated by one of our Tax Police Units to one of the most known operator of online market platforms;

- the second refers to a special project activity devised by the Special Revenue Unit and executed by the local units to private citizens/traders, operating on the online market, who have failed to declare in whole or in part its revenues to tax authorities.

## 3. TAX AUDIT OF A COMPANY ACTIVE AS AN ON-LINE MARKET PLATFORM

The business purpose of the Italian company, 95% controlled by a Swiss company, is the "Market researches and opinion polling," which is carried out according to a "Marketing, economy and technical consultancy" contract agreement with the mentioned Swiss company.

During the constant monitoring activity carried out by the Tax Police Units, it was ascertained that, over the years, the Italian company declared insignificant taxable income and turnover amounts that compared with those that it presumably should have had, in Italy, the best known worldwide technology platform for online sales. This data was mainly due to the fact that the Swiss parent company officially attributed the subsidiary with marginal tasks - essentially traceable to mere consulting activities – compared to the core business developed by the same group. Moreover, the agreement conditions, whilst explaining the activities carried out by the Italian company as merely of auxiliary and preparatory nature, seemed to rule out the configuration supposition of a permanent establishment in Italy of the Swiss parent company.

The verification of the documentation obtained at the offices of the Italian company, cross-checked with the statements made by its employees at the moment of the access, have allowed to obtain serious and concrete evidence on the possibility that, in fact, the same was a stable concealed organization, in Italy, of the Swiss company.

The actual activity carried out by the Italian company was deduced from the statements made by the employees, from the correspondence contents, also in an electronic format, found at the moment of the access, and "operational guidelines", realised by the Swiss parent company, which imposes the provisions according to which all the local entities of the group must follow whilst carrying out their activities. In this regard, it must be emphasized that the day in which the audit took place into the Italian company, the following was obtained:

- employee statements;
- computer data (e-mails, documents) present on some PCs located at the company headquarters and non-accounting documentation considered useful for the control.

In connection with the foregoing:

- the manager of the parent company was personally invited or requested to appoint a representative (provided with a special power of attorney) at the offices of the Department that performed the audit, for the start of the audit of the tax position in Italy of the Swiss company, for the fiscal years from 2001 to 2007;
- the assignment of the VAT and taxpayer's code of the permanent establishment in Italy of the Swiss parent company were requested.

Therefore, a tax audit was initiated into the Swiss parent company for the aforementioned fiscal years (2001-2007). The period under control during the audit was verified (period from year 2001 to 2007) due to the fact that Switzerland is included in the Italian black list and, for this reason, the audit period is doubled.

During the audit, the Guardia di Finanza Tax Police investigating personnel:

- collected further significant evidence confirming that the Italian company actually represented a concealed permanent establishment in Italy of the Swiss parent company;
- consequently, reconstructed the amount of the positive income elements and the turnover of the same entity.

In fact, from the analysis of the evidence collected during the audit, it was ascertained that, an organized system of man power and equipment existed at the premises of the Italian company, during the audit period in question, linked to the Swiss parent company by a functionality relationship subordinated to execution in Italy of the company activity through the Italian site (with the extension .it).

In other words, the Italian company developed a business activity, which produced income, through which the Swiss parent company carried out its business activities, integrating, therefore, a fixed place of business (identified by the application to a specific case, the place of business test), whose availability (obtained through the right of use test), from the functional viewpoint, it was inserted into a complementary relationship for the production of income (deducted from the business connection test).

In particular, the positive elements linked to the business derive from three kinds of sources. The first source is the "insertion fee", related to the possibility for the user to auction an item (tariff varies according to the initial price.) This amount must also be increased by sums deriving

from eventual other additional services requested by the user, that allow to highlight the item being auctioned, such as photos, captions, galleries etc.. The second profit source derives from the "final value commissions", which are applied as a percentage on the price for which the item is sold. The third profit source derives from the "Virtual Stores", for whose activity is attributed a "monthly subscription fee."

The existence of the requirements (objective, subjective and functional), useful for the configuration of a permanent establishment in Italy of the Swiss parent company, were deduced from the following elements:

- the existence in Italy of a fixed place of material installation through which the Italian company carried out its activity in an instrumental and auxiliary manner;
- the organization, in Italy, of assets and human resources in an appropriate manner for the production of the entire income developed in Italy through the Italian site. In this regard, it is emphasized that, although the explanatory report attached to the contract described the services provided as mere provision of consulting services provided to the parent company, the same, according to the outcome of the audit, were actually related to a real business management of the virtual platform, whose proceeds, however, were channelled to the Swiss parent company;
- the availability of such a place was, according to the information obtained, continuative and such to integrate the requisite of the activity fixity on the national territory. The establishment of the Italian company coincided with the setting up of the Italian site;
- the tax liability of the income produced in Italy by the parent company was, in fact, eluded, due to the signing of the contract for the above mentioned "marketing, technical and economy consultancy agreement" services, artfully carried out with the only aim of concealing the real activity carried out by the Italian company.

In the present case, the activity carried out by the Italian company had a direct impact on the core business of the parent company that, it is worth repeating, is based on the economic exploitation (realized by applying rates to the mentioned services rendered) of a virtual platform in which the supply and demand of goods meet in an autonomous way.

In fact, a direct relationship between this particular type of business and the actions carried out by the Italian company appeared clear. They were aimed at:

- making the Italian site more functional and usable;
- liaise with users (buyers and sellers) that, therefore, were found not to be in any auxiliary manner as willing to be understood through the provision of formally unexceptionable appropriate correspondence.

The above mentioned theory was confirmed by the contents of the employee statements and by emails obtained at the beginning of the audit.

Amongst the computer data obtained during the audit carried out into the Italian subsidiary company, "AAA Metrics" reports were found, from which it was possible to deduce the value of the transactions carried out through the Italian sales website and the related revenues, determined by applying the insertion fees on this value.

In particular, amongst other things, these reports indicate, monthly, the "GMV (gross merchandise volume)", or the value of goods sold in Italy, and the related "transaction revenues," or profits earned as a result of the transactions on the platform.

The audit carried out indicated the presence in Italy of a permanent establishment of the parent company, not formally established in Italy, for income tax and VAT purposes and, therefore, the Swiss parent company:

- assumed the role of a taxable subject in Italy;
- has never revealed the existence of this permanent establishment to the Italian Tax Administration;
- should have established and indicated separately, in its accounting books, the revenues deriving from the activity carried out in Italy and determine the total income on the basis of the profit and loss account regarding the management of the permanent establishment;
- should have submitted in Italy, as a taxable subject, the tax returns, in relation to the fiscal years for which it was ascertained that it conducted its business in Italy, that is from year 2001.

The tax audit carried out into the Swiss company ended up with the ascertainment of undeclared positive income elements, for IRES (Corporate Income Tax) and IRAP (Regional Tax on Production Activities) purposes, amounting to € 150.900.000,00 (almost 200 million dollars) and VAT due to € 30.180.000,00 (almost 40 million dollars).

During the audit, a document named "operational guidelines" was found whose analysis revealed well-founded reasons to believe that, also in other European countries where there is a shopping portal site like the one in question, behind a structure of the group formally with a legal and management autonomy and entrusted to carry out merely auxiliary activities may, in fact, conceal an undeclared permanent establishment of the Swiss parent company. In fact, the above mentioned "operational guidelines" contains directives addressed to "local offices"[1] so that they carry out the entire development and expansion activities of their respective national platforms allowing the same to formally appear as if carried out by the Swiss parent company.

As a result, pursuant to the former Directive 77/799/EEC, a spontaneous exchange of information has been initiated with:

- Austria;
- Belgium;
- France;
- Germany;
- Ireland;
- The Netherlands;
- Poland;
- United Kingdom;
- Spain;
- Sweden.

## 4. PROJECT ACTIVITY DEVISED BY THE SPECIAL REVENUE UNIT

The four different projects conceived by the Special Revenue Unit have been set out to:

- identify individuals who, on a continuous basis, in fact behaving like real entrepreneurs have been engaged in selling through major online portals, not fulfilling its obligations accounting, contribution and declarative provided by law;
- rebuild as a result, the volume of business for those entities;

as well as:

- identify the phenomena of failure to declare positive elements of income, resulting from e-commerce activities carried out on the platforms of online sales by persons known to the tax authorities;
- increase, consequently, the level of compliance of the category.

*1* The term used already indicates that the single National entities are considered places where the activity of the Swiss parent company are carried out.

The activities of the Special Revenue Unit - on directives from the General Headquarters -, was inspired by the analysis of all the reports drawn up by the Local Units at the end of every tax audit, from which emerged the identification of certain individuals who do not have a VAT number, which were registered on web-sites dedicated to online trading continuity over time, and that there have been selling goods and services without complying with the requirements imposed by the tax laws.

In this context, an analysis was conducted on data relating to persons who have carried out from 2004 to 2007, operations of e-commerce on the main international platform of online shopping and have identified some positions deemed "fiscally dangerous".

It is well known, in fact, that, thanks to numerous "on line shops", which offer many different services, ranging from simple publication of ads to the realization of real virtual stores, the internet is increasingly being used to carry out business activities in a hidden way.

The obvious consequences are, in addition to a lower revenue for the Tax Administration, also a distortion of the legal economy, damaged by unfair competition from traditional commerce.

The concealment of the proceeds to the Treasury is facilitated by the fact that, often, the management company of the above domains have in Italy, at least formally, a mere representative office, while the servers are allocated outside the national territory.

That said, the method of identification of risky positions was based on making a search with major international web searching engines to identify the "online markets" operating in Italy, meaning by this term all those sites that appear to act as intermediaries between subjects buyers and sellers:

- initially, promoting the meeting between their will by the insertion of offers;
- subsequently, telling the seller the bids received, which may follow, if necessary, the conclusion of the relevant contracts directly by the parties (ie without any intervention of the operator of the web site).

Among the domains detected, were selected those with sponsored links, ie those that do not just post free ads, but who receive a fee (fixed or variable) for the publishing real "online shops" or just simple goods to sell.

Once identified the companies interested a formal request was sent to acquire the data of persons who have made on line sales of goods for a total annual amount not less than 10.000,00 euro (13.000 $), referring to the tax year ranging from 2004 to 2007.

The data obtained, enriched with all the information available in the tax data base (Anagrafe Tributaria), were also crossed with other databases such as: Guardia di Finanza DB (PIGRECO) and the Suspicious Transactions DB (SIVA) in order to verify the possible existence, in relation to those subjects, of previous operations carried out in all Italy by the local Units and/or suspicious transaction reports.

At the end of the activity carried out by the local Units, 391 tax audits were performed, 242 persons completely unknown to the tax administration were detected, approximately 110 million of euro (145 million of dollars) of undeclared tax base was detected and more than 20 million euro (more than 26 million of dollars) of VAT due.

# TOPIC 2

# PRESUMPTIVE TAXATION AND THIRD PARTY INFORMATION SOURCES

*Lecture*

*Topic 2*

# PRESUMPTIVE TAXATION AND THIRD PARTY INFORMATION SOURCES

**Binod Sinha**
Commissioner of Income Tax
Coordination & System, Central Board of Direct Taxes
(India)



## 1. INTRODUCTION

The system of direct taxation in India has been in force since ancient times. One gets several directives in ancient texts which mention as to parameters of taxation as well as the procedure to be followed. The principle advocated by the sages, who acted as advisors to the administrators of the ancient time, was that the taxes should be collected from the people in such a way that it does not hurt them. In his acclaimed treatise on governance and economics "Ärthshastra", Kautilya who is known as the father of Economics, pronounces that the King should collect taxes from his people in the same manner that the honeybee collects nectar from the flowers. The same is being understood and adopted in the present day with a vision and mission that only the right amount of taxes are collected in the most right way. There is a renewed emphasis on encouraging voluntary tax compliance as use of non-intrusive methods of collection of taxes rather than using intrusive actions for the purpose.

'Presumptive Taxation' is one of the techniques for encouraging voluntary compliance among small taxpayers as such schemes ensure the lower compliance costs for the taxpayers. This document focuses on various provisions of Indian Tax laws dealing with presumptive taxation. It also focuses on ways and means adopted by the Indian Tax administration in accessing the information in possession of third

parties such as banking, financial entities, stock exchanges, etc. and the use of technology in aiding the tax administration in the collation, management and usage of information in possession of these institutions.

## 2. PRESUMPTIVE TAXATION

Presumptive Taxation can be defined as a form of assessing tax liability using indirect methods such as income reconstruction or by applying base-line taxation across the entire tax base. Presumptive methods of taxation are thought to be effective in reducing tax avoidance as well as equalizing the distribution of the tax burden. Though with more than 150 years of history of direct taxation in modern times and a substantially advanced and capable tax administration, the basic principle followed is that of self-assessment by the taxpayer and risk based auditing by the Tax Officers in only a few cases, the Indian Income Tax Act also incorporates provisions for presumptive taxation in respect of certain class of cases including small domestic businesses and specific foreign entities conducting business in India. Such a presumptive taxation scheme ensures the twin benefits of lower cost of compliance for the taxpayer as well as lower administrative burden for the Government.

Presumptive taxation involves simple techniques to capture income that frequently escapes conventional taxation. Typically, the income is determined as a percentage of the turnover, and the balance amount is allowed as a reasonable amount of deduction.

Except for the turnover, the taxpayer is not required to maintain detailed books of accounts. If a business pays tax as per these criteria, then the tax declaration is accepted without further investigation. Alternately, if the taxpayer claims that the income generated from the business is below the threshold, then it has to maintain detailed accounts and the same is subject to detailed investigation.

Under presumptive taxation, the tax is charged on such presumptive income, in order to save compliance cost and administrative cost. It brings horizontal equity within a single type of business. The major disadvantages of presumptive taxation are, it is less accurate and lacks progressivity, it ignores efficiency of a business and ideally the parameters determining the profit margin require to be updated periodically.

Nevertheless, simplicity and reduced compliance cost under Presumptive taxation makes a strong case for its adoption for taxation of small and medium enterprises.

## 2.1 Presumptive taxation scheme exclusively for certain businesses carried on by resident Taxpayers

### a. Presumptive taxation scheme for all businesses except transport business

A presumptive Taxation Scheme for small income groups was introduced during 1993 which was subsequently revised during 1998 and further revised during 2009. In its present form, Section 44AD of the Indian Income Tax Act, 1961 ("the Act") provides for presumptive taxation of resident taxpayers being an individual or a Hindu Undivided Family (HUF) or a partnership firm (other than limited liability partnership firm) carrying on any business other than the business of plying, hiring or leasing trucks for transportation of goods with a gross turnover which does not exceed INR 10 million (USD 167,000). However, the businesses of commission agent, broker and agency have been taken out of the ambit of the scheme in view of the higher profit margin in these businesses.

The presumptive rate of income is specified at 8% of gross turnover / gross receipts.

However, a taxpayer could voluntarily declare a higher income in his return. The scheme is optional for the taxpayer. A taxpayer opting for this scheme is not required to maintain detailed books of accounts of such business which is otherwise required under section 44AA of the Act.

The presumptive scheme is not available to a taxpayer who has availed deductions under sections 10A, 10AA, 10B, 10BA as available to newly established businesses in free trade zones, or special economic zones or 100 % export oriented undertakings or to taxpayers engaged in export of specified articles or things or deduction under any provisions of Chapter VIA under the heading "*C.*—Deductions in respect of certain incomes" in the relevant assessment year.

All deductions for business expenditure under sections 30 to 38 of the Act including depreciation are deemed to have been allowed and no further deduction is to be allowed under these sections. Further, any eligible taxpayer opting for the above scheme is also not required to pay advance tax in respect of income of such business.

However, if any taxpayer, who is otherwise eligible under the presumptive taxation scheme, shows an income which is less than the presumptive rate specified under section 44AD, is required to maintain detailed books of accounts and also get the same audited by an independent Accountant, if his total income exceeds the taxable limit.

**b. Presumptive taxation scheme for transport business**

The presumptive taxation scheme for transportation business was introduced during 1994, with a view to provide for a method of estimating income from the business of plying, hiring or leasing trucks owned by a taxpayer. It is not applicable to the persons who do not own any truck but operate trucks taken on hire. As contained in provisions of section 44AE of the Act, the scheme applies to persons owning not more than ten trucks. The taxpayer shall be deemed to be the owner of goods vehicles taken on hire purchase or on installment, whether whole or part of the amount is payable, when such vehicles are in possession of such taxpayer. However unlike the presumptive scheme for small businesses as described above, there is no restriction in terms of the category of the taxpayer or the threshold of gross turnover.

The income from each truck, being a heavy goods vehicle, is estimated at INR 5000 (USD 83) for every month or part of a month during which the truck is owned by the taxpayer. The income from each truck, other than a heavy goods vehicle, is estimated at INR 4500 (USD75) for every month or part of a month during which the truck is owned by the taxpayer. However, in either case, the taxpayer can declare his income from trucks at a higher amount than that specified above.

All deductions for business expenditure under sections 30 to 38 of the Act including depreciation are deemed to have been allowed and no further deduction is to be allowed under these sections. However, there are no specific provisions exempting these taxpayers from payment of advance tax.

If any taxpayer, who is otherwise eligible under the presumptive taxation scheme, shows an income which is less than the presumptive rate specified under section 44AE, he shall be required to maintain books of accounts and also get the same audited by an independent Accountant, if his total income exceeds the taxable limit.

**c. Tonnage Tax Scheme for Indian shipping company:**

In order to make the Indian shipping industry more competitive, the Finance (No.2) Act, 2004 introduced a tonnage tax scheme in the Act for taxation of shipping profits (Chapter-XII-G).

Some of the basic features of the tonnage tax scheme under the Act are as follows:-

- An Indian company owning at least one qualifying ship may join the scheme.
- It is a scheme of presumptive taxation whereby the notional income arising from the operation of a ship is determined based on the tonnage of the ship.
- The notional income is taxed at the normal corporate rate applicable for the year.
- Tax is payable even if there is a loss in a year.
- A company may opt for the scheme and once such option is exercised, there is a lock in period of ten years. If a company opts out, it is debarred from re-entry for ten years.
- Since this is a preferential regime of taxation, certain conditions like creation of reserves, training etc. are required to be met.
- Certain types of ships like fishing vessels, pleasure crafts etc. are excluded from the ambit of scheme.
- The business of operating qualifying ships is considered as a separate business and separate accounts are to be maintained.
- A company opting for the scheme is not allowed any set-off of loss nor is any depreciation allowed.
- The profit from the business of operating, qualifying ships is not taken into consideration for the purpose of levying Minimum Alternate Tax (MAT).

## 2.2 SECTION – II: Presumptive taxation scheme exclusively for certain businesses carried by non-resident

Besides above presumptive taxation schemes, the Act also contains special presumptive schemes for estimating income of certain businesses carried by non-residents which are enumerated below:

**Computation of income in respect of shipping business carried on by non-residents:**

Section 44B of the Act provides that a sum equal to 7.5% of the (i) amount paid or payable on account of carriage of passenger, livestock, mail or goods shipped at any port in India; and (ii) amount received or deemed to be received in India on account of carriage of passenger, livestock, mail or goods shipped at any port outside India, shall be deemed to be the profits and gains of such business.

**Computation of income in respect of business of exploration etc. of mineral oils**

Section 44ABB of the Act provides that in case of a **non-resident** engaged in the business of providing services or facilities in connection with, or supplying plant and machinery on hire for exploration etc. of mineral oils, a sum equal to 10% of the (i) amount paid or payable on account of provision of services and facilities in connection with, or supply of plant and machinery on hire for exploration etc. of mineral oils in India; and (ii) the amount received or deemed to be received in India for provision of services and facilities in connection with, or supply of plant or machinery for exploration etc. of mineral oils outside India shall be deemed to be the profits and gains of such business.

These provisions are not applicable where the provisions of section 42 (special provision for deduction in the business of exploration, etc. of mineral oils), or section 44D or section 44DA (special provisions for computing income by way of royalties) or section 115A (special provision of tax on dividends, royalties and technical service fees in the case of foreign companies) or section 293A of the Act are applicable.

These provisions also provide an option to declare profit lower than specified percentage. However, in that case, the detailed books of accounts are required to be maintained and the same are required to be audited by an independent auditor. Such a case is to be audited by the tax officer under section 143(3) of the Act.

**Computation of income from operation of aircraft in case of non-resident:**

Section 44BA provides that in case of a non-resident assesse engaged in the business of operation of aircraft, a sum equal to 5% of (i) the amount paid or payable on account of carriage on passengers, livestock, mail or goods in any place in India; and (ii) the amount received or deemed to be received in India for carriage of a passenger,

livestock, mail or goods outside India, shall be deemed to be the profits and gains of such business.

**Computation of income of foreign companies engaged in the business of civil construction**

Section 44BBB provides that in case of a foreign company engaged in the business of civil construction or the business of erection of plant or machinery or testing or

commissioning thereof, in connection with a turnkey power project, a sum equal to 10% of the amount paid or payable on account of such civil construction etc., shall be deemed to be the profits and gains of such business.

The section also provides an option to declare profit lower than the specified percentage if the company maintains detailed books of accounts and get the same audited by an independent auditor. Such a case is to be audited by the tax officer under section 143(3) of the Act.

## 3. USE OF THIRD PARTY INFORMATION SOURCES FOR WIDENING & DEEPENING OF TAX BASE AND ITS IMPACT ON PRESUMPTIVE TAXATION SCHEME:

Indian Income Tax Act has several provisions which authorize the tax authorities to collect information from taxpayer or any other person holding information about the taxpayer. The tax officer can ask a taxpayer to produce such accounts, documents etc. before him as he may require for determining the correct taxable income of the taxpayer. The tax officer may also direct any person including a banking company to furnish information regarding any taxpayer which the officer thinks, will be relevant to any proceedings or enquiry under the Income tax Act. However, most of these provisions are taxpayer specific and some of the provisions can be used only if some proceedings under the Act is pending before tax authorities.

In the recent times, the focus of Indian Tax administration has seen a paradigm shift; moving from the era of collection of information on economic transactions directly from the tax payers during and for the purpose of audit to setting up a model in which the flow of information is automatic and continuous. The Tax Administration receives third party information from both internal and external sources as under:

(a) Information received under the Annual Information Return System
(b) Information obtained under the Central Information Branch System

(c) Information received from stock exchanges
(d) Information received from tax withholders
(e) Information received from Foreign Tax Authorities under DTAAs or TIEAs.

### a. Information received under the Annual Information Return System

Under the Annual Information Return System, which was introduced in 2003-04, the specified entities are required to report to the Tax administration the specified transactions as depicted in the Table hereunder:

| Sl. No. | Class of person | Nature and value of transaction |
|---|---|---|
| 1. | A Banking company to which the Banking Regulation Act, 1949 applies. | Cash deposits aggregating to Indian Rupees (INR) one million or more in a year in any savings account of a person maintained in that bank. |
| 2. | A banking company to which the Banking Regulation Act, 1949 applies or any other company or institution issuing credit card. | Payments made by any person against bills raised in respect of a credit card issued to that person, aggregating to Indian Rupees (INR) two hundred thousand or more in the year. |
| 3. | A trustee or the manager of the Mutual Fund as may be duly authorized by the trustee in this behalf. | Receipt from any person of an amount of Indian Rupees (INR) two hundred thousand or more for acquiring units of that Fund. |
| 4. | A company or institution issuing bonds or debentures. | Receipt from any person of an amount of Indian Rupees (INR) five hundred thousand or more for acquiring bonds or debentures issued by the company or institution. |
| 5. | A company issuing shares through a public or rights issue. | Receipt from any person of an amount of Indian Rupees (INR) one hundred thousand or more for acquiring shares issued by the company. |
| 6. | Registrar or Sub-Registrar under the Registration Act, 1908. | Purchase or sale by any person of immovable property valued at Indian Rupees (INR) three million or more. |
| 7. | An officer of Reserve Bank of India duly authorized by the Reserve Bank of India in this behalf. | Receipt from any person of an amount or amounts aggregating to Indian Rupees (INR) five hundred thousand or more in a year for bonds issued by the Reserve Bank of India. |

The Salient features of the AIR scheme are as below:

- The filing of AIRs by the persons specified by the tax administration in the statutory Act has been made mandatory. Failure to file AIRs by such persons invites penalty under the provisions of the Act.

- The format in which the data is to be collected and supplied to the tax administration has been designed which incorporates necessary fields to make the data usable.

- A unique identification number called as PAN (Permanent Account Number) was allotted to every taxpayer. At the time of entering into above mentioned specified transactions, a tax payer is required to mandatorily quote his or her PAN to the class of persons mentioned in the above table. PAN is very useful in correlating with the information filed by the tax payers in their tax returns.

- The specified persons are also required to mention the PAN against each transaction while filing the Annual Information Return (AIR) with the Tax administration. Failure to mention PAN by tax payers at the time of entering into specified transactions invites penalty under the provisions of the Act.

- In case the individuals who state that they do not have PAN as they have income below the taxable limit, in that case it is mandatory for them to give a declaration to that effect and also give his/ her details in the prescribed form.

- Such information collated by the specified persons is to be supplied to the tax administration by way of filing a return called as 'Annual Information Return'. The form in which it is to be supplied has been standardized. It has also been made mandatory that the information has to be necessarily filed with the tax administration in electronic format. This is for enabling the tax administration to run/ process the data and correlate the same with the data filed by the tax payers in their tax return.

- The information received through Annual Information Return is then matched with the information provided by the taxpayers in their income tax returns. Cases of mismatch are selected for audit so as to determine the correct income of the tax payer on which he is required to pay the due taxes.

The 17 Intelligence Directorates located all across the length and breadth of the Country implement and administer the AIR Scheme in terms of statutory functions incorporated in section 285BA of the Act and Rules 114B to 114D of the Income Tax Rules. This arm of the

tax administration monitors the filing of AIR and issue notices to the non-filers /late filers as well as to such filers who file defective AIRs for filing rectified supplementary AIRs. In cases of non-filers, they also initiate penalty proceedings u/s 271FA of the Act and impose such penalties in appropriate cases. During the Financial year 2012-13, action was initiated against non-filers as well as the filers of defective AIRs through issue of statutory notices. Notices were issued in **1467** cases of filers of defective AIRs and **3878** cases of non-filers of AIRs. Penalty notices were issued u/s 271FA in **1252** cases and penalty was imposed in **225** cases.

This system with the extensive use of information technology has brought commendable results within a period of 8 years since its introduction. The growth rate in tax collections and tax payers' compliances stand testimony to this statement. The system of AIR was introduced in India in the year 2003-04. Since then, the net direct tax collection has increased by 370% and the number of taxpayers has increased by 15.50%.

**b. Information obtained under the CIB system**

Besides the AIR system, the Tax administration also continues to obtain information about specific financial transactions up to prescribed thresholds as entered into by the taxpayers under the Central Information Branch system. The 17 Directorates of Intelligence also collect information under various CIB codes u/s 133(6) of the Act and disseminate the same through facilities created in the ITD systems, from time to time.

For this purpose the sources of third party information have been identified on the basis of economic activities involved. There are some activities about which the data is obtained compulsorily by the Tax Intelligence Officers and there are others in respect of which obtaining the data has been made optional depending on the economic realities of a particular area or region of the country. Following are the some of the financial transactions for which the information is being collected by tax administration under this system:

- Sale of immovable property valued at INR. 500,000 or more (but less than INR. 3,000,000) (Value assessed for stamp Duty)
- Information relating to transfer of capital assets where value declared for the purpose of Stamp Duty is more than sale value. Information collected to include names and addresses of seller, date of transaction, amount of sale consideration and value upload for stamp duty purposes.

- Time deposit exceeding INR 200,000 with a banking company.
- Deposit exceeding INR 200,000 in any account with Post Office Savings Bank.
- Sale and purchase of motor vehicle valued at INR 500,000 and above.
- Payment to hotels and restaurants against their bill for an amount exceeding INR 100,000 at any one time
- Deposit in cash aggregating INR 200,000 or more, with banking company during any one day.
- Payment in cash in connection with travel to any foreign country of an amount exceeding INR 100,000 at any one time

Besides above, the tax administration is also collecting information from telecom companies, Clubs, spas, Electricity supplying entities, Real Estate companies, other tax departments such as Customs, Excise, other government agencies etc.

While the data collected under CIB which has unique identification number known as Permanent Account Number (PAN) of the taxpayer is uploaded into the ITD System for being used in Computer Aided Scrutiny Selection (CASS), the Non-PAN CIB data is available for viewing by the Tax Intelligence Officers. Out of the Non-PAN CIB data, limited numbers of cases are selected for verification on the basis of threshold and numbers as prescribed by the Head of Tax Intelligence and outcome of such verification is disseminated to the field offices for further necessary action.

During 2012-13, the Intelligence Directorates collected **over 200 million** pieces of information from different organizations and after cleaning and collation over 170 million pieces of data was uploaded on the intranet of the Indian Income Tax Department for matching with the taxpayer's data.

### c. Information received from Stock Exchanges

Rule 6DDA of the Income Tax Rules provides that the recognized stock exchanges are required to maintain all data, pertaining to the transactions undertaken by the traders in the market, for a period of 7 years. This is necessarily maintained by stock exchanges as a tax namely 'Security Transaction Tax' is levied on the transaction made through stock exchanges. In Indian tax system, Stock exchanges are responsible to collect such tax and remit to the government treasury. This ensures that as and when the Tax administration wants to obtain data of specific values, the same can be provided by the stock exchanges.

Further, the stock exchanges are to report specified type of data/ transactions (high risk transactions) at stipulated intervals to the Intelligence Directorate. Such information, after analysis, is, in turn, passed on to the officers dealing with the tax matters of the tax payers concerned.

**c. Information received from tax withholders**

Under the provisions of the Income Tax Act, while making payment on account of Salary, Interest, dividend, payment to contractors, rent, commission, brokerage, fees for professional and technical services, etc, the payer is required to withhold a specified portion (TDS) of amount payable and deposit the same in the government account. The TDS deductors are also required to periodically file the TDS returns with the tax administration. These TDS returns are required to be filed electronically and contain information such as name, address and PAN of payee, nature of payment, amount, date, amount of TDS made, date of TDS deposit in government account etc. Information filed in these TDS returns is also available to the Tax administration for matching with the information filed by the tax payers in their tax returns.

**d. Information received from Foreign Tax Authorities**

India has also widened its Double Taxation Avoidance Treaty network over the years and has also entered into Tax Information Exchange Agreements (TIEAs) with many countries. Currently India has 86 DTAAs and 13 TIEAs with other countries, which are in force. The Indian Tax Administration, as a consequence of this, receives significant volumes of information under the Automatic Exchange of Information as well as under Spontaneous Exchange of Information regarding Indian tax payers.

There are separate Standard Operating Procedures(SOPs) prescribed for dealing with information received from any Foreign Tax Authority under Automatic Exchange of Information , Spontaneous Exchange of Information as well as specific references received in specific cases. The SOPs have been made part of Manual on Exchange of Information, so that the same are uniformly followed by all the Tax Officers.

All the officers concerned in the above process should strictly follow the confidentiality provisions of the treaties including the computer data protection.

## 4. SECTION – IV: Possible impact of the third party information on the presumptive taxation Schemes

The possible impact of the third party information as available with the Tax administration can be summarized as under:

1. The third party information available with the Tax Officer may indicate that the taxpayer has supressed his gross turnover or gross receipts but the overall threshold for being eligible for presumptive taxation has not been breached. In such a case, the amount of assessable income will increase in absolute terms.

2. In another scenario, the Tax Officer may have third party information which may establish that the actual gross turnover of the taxpayer was higher than the prescribed threshold which makes him ineligible for presumptive taxation. In such a case, the Tax officer may select the taxpayer's case for investigative audit and confront him with the evidence asking him to establish as to how he claims that his turnover below the prescribed threshold (INR 10 million) and that he falls within the eligible category for presumptive taxation. If the taxpayer fails to establish his eligibility in the face of the third party information available with the Tax Officer, the Tax Officer will assess him in normal course and will not give him the benefit of presumptive taxation. All adverse actions for non-maintenance of accounts and non-auditing thereof as well as non-payment of advance Tax will follow.

3. The Tax Officer may have third party information about transactions entered into by the taxpayer indicating deposit of large sums of cash in bank, or investment in immovable or movable properties which may not be commensurate with the income reported by the taxpayer in his tax returns. In such cases also, the Tax Officer may seek clarification from the taxpayer for arriving at the correct amount of taxable income other than the business income eligible for presumptive taxation. Where the taxpayer is not able to satisfactorily explain such transactions, the same may be assessed as income from undisclosed sources and tax liability can be determined thereon.

4. The tax payers are now aware that information of their financial transactions is being collected by the tax administration. It has a deterrent effect. There is improved voluntary compliance with regard to the disclosure of such transactions as the tax payers are aware that the tax administration will come to know about them from other entities even if they do not disclose.

## 5. CONCLUSION

In conclusion, we may summarise the basic features of the presumptive taxation scheme under the Indian Income Tax Act, 1961 and the interplay between the same and the third party information available with the Tax Officer as under:

(a) For residents, the presumptive scheme is available only to eligible categories of taxpayers engaged in eligible businesses.

(b) For non-residents, the presumptive scheme is available only to taxpayers engaged in specific businesses carried out in India.

(c) In both cases, (of residents and non-residents) the presumption is mainly about the income component embedded in the gross receipts of the specified businesses with the exception of the residents engaged in business of hiring or plying transport vehicles in respect of whom the income component is calculated on the basis of specified sum multiplied by number of vehicles (with an upper threshold of maximum ten vehicles) and in the case Indian Shipping Companies in whose case a tonnage tax is exigible.

(d) The presumptive taxation scheme is optional and the taxpayer has the option to come out of the presumptive scheme and claim lower than presumed income provided he can establish lower than presumed profits and gains out of his business activities;

(e) The Tax Officer also has the option to vary the turnover on the basis of evidence in his possession including third party information.

(f) The presumption is only with regard to profits and gains of eligible businesses and they do not override the provisions regarding income derived from sources other than such eligible business as well as provisions regarding assessment of unexplained cash credits, unexplained investments or money, unexplained investment not fully disclosed in the books of accounts, unexplained expenditure etc. Consequently such amounts of credits, cash, investments or expenditure will be assessed as income of the taxpayer over and above the presumed income from eligible business.

*Lecture*

*Topic 2*

# PRESUMPTIVE TAXATION AND THIRD PARTY INFORMATION SOURCES

**Juana Maribel Sea Paz**
Examination Professional I
National Tax Service
(Bolivia)

***Contents:*** *1. Summary.- 2. Background .- 3. Types of presumption in Bolivia.- 4. Presumptions that accept contradictory evidence .- 5. Regulation of the methods for the tax determination on presumptive basis.- 6. Conclusions*

## 1. SUMMARY

On August 2, 2003 the law No. 2492 "Bolivian Tax Code" was published, establishing determinations on real or presumptive basis, according to the circumstances and the knowledge of the taxable event.

To specify the tax debt, it is essential to know whether the documentation and information of the tax administration is directly and reliably related to the taxable event, considering the information provided by the taxpayer or a third party as directly related to the taxable event, and the information must be reliable.

Given the technological changes from 2003 to 2013 and the increase in the number of taxpayers, the development of software tools allowing and efficient use of the information was a priority, which led to the development of different systems for saving, storing and using the information. A series of tools were also implemented for collecting information, accompanied by rules defining the source as "Information Agents". As a result, the information from various sources is currently available, allowing crossings of information for the control processes, originating among others from banking, VAT purchases and sales registries, financial reports, third party information, etc... These crossings relate directly and reliably to the taxable events and allow the determination of the taxable income for a specific period, as well as its use for projecting other periods or to determine the taxable base on a presumptive basis.

On this last form of determination, in May 2013, the National Tax Service has issued a regulation for ensuring the determination or control processes, in order for it to be as close as possible from the facts and the taxpayer's economic reality.

## 2. BACKGROUND

The Bolivian Tax Code no. 2492 of August 2, 2003 establishes the determination of the taxable income on real basis and presumptive basis, specifying that the presumptive basis is applied when the administration requires documentation and information not provided by the taxpayer and therefore not available to directly determine the taxation events.

On the other hand, it is important to note that the information available to the tax administration through databases is directly related to the taxable event; therefore this information usually contributes to the control processes.

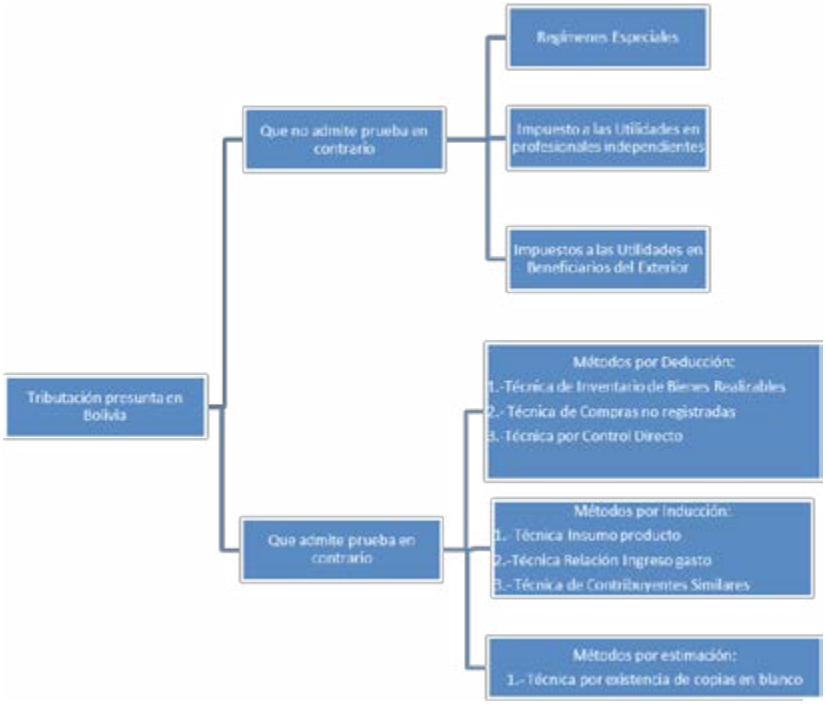
The determination on presumptive basis is performed when the taxpayer has not submitted the documents and when the determination on real basis cannot proceed, whereby law No. 2492 establishes the determination of the tax base on presumptive basis, which should be specified by the tax administration regulations.

For the last 10 years, no specific regulation had been issued; therefore the determination on presumptive basis was performed according to the available information, so the judicial cases were not satisfactorily resolved. Because a normative instrument supporting the procedures used for the determination on a presumptive basis was missing, there were no possibility for contradictory evidence; for this reason, the present administration, under article 64 of the law No. 2492 of the Bolivian tax code, has issued a normative resolution giving to the tax administration the power to dictate general administrative regulations to implement the tax legislation.

This resolution establishes some presumptions and details techniques to be used in the determination process on presumptive basis for approaching as much as possible the truth of the facts and the economic reality, which will provide highly documented control processes, thus minimizing the risk of litigation.

## 3. TYPES OF PRESUMPTION IN BOLIVIA

The following is a brief outline of the presumptive basis currently existing in Bolivia:




According to this scheme, the presumptive basis in Bolivia includes two modalities: those which do not accept contradictory evidence, on which the taxable base is obtained by applying fixed percentages established by law. For example we can mention the tax on independent professionals' enterprises profits, where it is "presumed" that 50% of their income is the taxable profit. However this form of presumption has no third party information source; this is why this presentation will develop the presumptions that admit contradictory evidence.

## 4. PRESUMPTIONS THAT ACCEPT CONTRADICTORY EVIDENCE

This kind of presumptions are used in determination processes, i.e. tax audits which source of information is obtained from the taxpayer for previous periods or periods following the control, and information from third parties.

For the determination on presumptive basis, two sources of information are used:

a) Internal: information from the SIN database or from the taxpayer returns, accounting statements, etc. and information from customers and/or suppliers related to commercial transactions with the controlled taxpayer. In some cases information from other entities is used as information agents, as for example the credit cards administrators, utilities and others.

b) External: Information directly requested to third parties regarding the taxpayer's activity.

Obtaining this information allow the determination on presumptive basis to be as close as possible to the economic reality of the taxpayer and the truth of the taxable event.

After the new tax code law Nr. 2492 was published, for ten years audits have been performed by applying presumptive techniques. Some results were favorable to the tax administration; however some others were lost due to a lack of regulation on the methods applied. Consequently, under these circumstances, last May, the National Tax Service has issued the Directory Resolution 10-0017-13 "Regulation of the tax determination techniques on presumptive basis", establishing the conditions that must be fulfilled and the methods for the determination on presumptive basis, through induction, deduction and estimates techniques.

## 5. REGULATION OF THE METHODS FOR THE TAX DETERMINATION ON PRESUMPTIVE BASIS

Directory Resolution 10-0017-13 issued on May 8, 2013, clarifies the circumstances for the determination on presumptive basis, the elements that could be used and the techniques to be applied.

a) Situations

The tax administration may determine the tax base using the presumptive basis method, only when the data for the determination on real basis were requested and not provided by the taxpayer, and specifically, when at least some of the following situations are verified:

1. The taxpayer is not registered in the corresponding tax registries.
2. No return is submitted or basic data on the returns are omitted, in accordance with the determinative procedure for special cases provided by this code.

3. If there are behaviors that ultimately do not allow the development of the control activities.
4. If accounting books registries or the supporting documentation or reports regarding compliance with the provisions are not provided.
5. If some of the following situations take place:

    a) Omission of the operations registry, income or purchases registries, as well as changes in prices or costs.
    b) Registration of purchases, expenses or services not performed or not received.
    c) Omission or changes in the stock registry that must be included in inventories, or if such stocks are registered with prices different from the real costs.
    d) When stock valuation regulations or the control procedure required by tax regulations are not followed.
    e) Changes in the tax information on magnetic, electronic, optical or computerized supports, making impossible the determination on real basis.
    f) Existence of more than one set of accounting books, manual or computer records, records of any type or accounting system, with non-matching data and/or information of tax interest for the business activity.
    g) Destruction of the accounting records before prescription.
    h) Tax controls avoidance, non-use or misuse of seals, stamps, and other means of control; changes in product characteristics, their concealment, change of destination, false description or false indication of source.

Situations that prevent to know the real operations, or in any case which do not allow performing the determination on real basis.

**b) Elements (Third party information sources)**

In this regulation, the Tax administration establishes that for the determination of the tax Base on presumptive basis, all data or taxpayers' records from the previous periods must be applied, including tax bases for related taxes, which are more important than the information from similar taxpayers.

Regarding the information sources available to the national tax service, we can mention two types, the information agents and the third party information, which are developed as follow:

**I. Information agents:** It is the information submitted by the taxpayer or related taxpayers on a monthly base and registered in the SIN database, these are:

a) VAT purchase and sales books registries, taxpayer's monthly purchases and sales invoices, reporting the VAT for a given tax period. This information is used in determination processes making information crossings with customers or suppliers in order to identify income for different periods or applying some of the techniques that we will mention later, and that could be used as information to determine income from other periods on a "Presumptive basis" as an economic projection, estimate or deduction.

b) The banking module records the information of transactions of purchasing and sales exceeding Bs.50, 000 that according to laws should be supported with payments guaranteed by banks; the taxpayer must register these movements on a monthly basis; this reliable information is generally used for determinations on real basis. In some cases it is used as an income and expenses levels parameter.

c) Hospitals were considered as information agents regarding medical professionals, allowing the determination of income on real basis in a given period for medical professionals or hospitals, and the use of this information is also allowed as a presumptive basis to estimate the taxpayer's activity.

d) Power suppliers regularly submit information on electric power consumption. This information is primarily used in the revision of production processes, industries or a trade not registered and is very useful for the determination on presumptive basis since it constitute evidence to estimate the taxpayer's real production.

e) Credit cards companies are information agents for credit card purchases and sales and allow the determination of a specific revenue amount spent with credit cards; when there are differences with the tax return submitted by the taxpayer, this source of information allows the determination on real basis or in some cases an income level estimate.

f) The International Association of Air Transportation (IATA) as an information agent sends periodic details on airline tickets issued by airlines regulated by this organization, and they are used for verifying the taxpayers' purchases or expenses, airlines income, verification of free tickets, etc. This information is currently only used for the determination on real basis.

g) The information collected about the production parameters (F. 630) requires data on inputs or raw materials used to control production companies. This information can be used for real or presumptive determination according to the documentation and information available.

h) The information collected from Bolivian Tax Oil Fields and gas stations as information agents related to the trade of hydrocarbons allows determining their reported income, used for the determination on real basis of the taxpayer income and in some cases such information could help for determining similar taxpayers' income on presumptive basis technique.

i) The Financial statements electronically submitted by taxpayers each year can be used for the determination on both bases considering the tax rate and additional documents available; this information is mostly used in presumptive basis determination processes, reflecting the level of revenue and expenses, balance of inventories, percentages of losses, fixed assets available, utility margins, etc. This information is used for the controlled periods.

| INFORMATION Agents |
|---|
| VAT sales and purchase books |
| BANKING module |
| Hospital module |
| Power suppliers |
| Credit cards |
| IATA |
| 630. specific production parameters – Specific consumption taxes |
| YPFB and<br>Gas stations |
| Financial statements |

Taxpayer or information agent send them periodically and they are considered direct and usually unquestionable information, which serve for determination on presumptive bases, allowing estimates for other periods

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**II. Third party information upon TA request**

It is directly related to the determination and is requested according to the taxpayer to be controlled, the tax periods and taxes subject to control. For example we can mention information from control entities or bank statements.

**c) Applied techniques**

The following is a summary on tax audit techniques.

**I. Deductive techniques** applying data, background and indirect elements that allow deducing the existence of the taxable event and its size. These techniques are:

i. **Assets inventory**: It consists in carrying out the estimate of inventories, to determine unreported income; it is based on information from the financial statements of the previous and subsequent tax periods.

**ii. Non-registered purchases**: When the taxpayer does not register VAT in the accounting books, local purchases or imports, detected by third parties or other sources, sales not invoiced or declared shall be presumed for all imported or sold items.

iii. **Direct control:** This technique involves controlling the taxpayer facilities and /or economic activity, by tax administration officials, in not less than three (3) business days in the same month, considering the average activity volume, for obtaining an average daily income, which will be multiplied by the amount of business days in order to obtain the monthly income.

II. **Inductive Techniques.** Using those elements to indirectly prove the existence of goods and income as well as sales, costs and yields which are normal in the respective industry, considering the characteristics of the economic units to be compared. These techniques are:

i. **Product input** : In cases of property subject to a production process, the relationship of technical production coefficients must be established, emphasizing the assessment of the raw materials costs or other major inputs for obtaining the product cost and compare it with the one reported by the taxpayer.

ii. **Relation between income and expenses**: It consists in establishing the level of expenses and verifying if they correspond to the reported income level, as well as investments.

iii. **Similar taxpayers:** When the tax administration can not access data or related facts, the presumptive determination basis is applied taking into account the information obtained from similar taxpayers, through a comparative analysis of taxable bases. Similar taxpayers are those performing the same economic activity and with similar tax obligations, that meets comparability requirements.

III. **Techniques through estimates**: Assessing indexes or modules from the respective taxpayers according to their data or background information. The most applied is the following:

i. **Existence of blank invoices, not submitted or partially submitted**: If there are copies of blank invoices, (i.e. invoices that do not state any information), or if the information required by the Tax Administration is not submitted or partially submitted by the taxpayer, for these invoices that are not registered or are missing or were not reported by third parties, it will be presumed that the original document was used for the sale of goods or services and was issued. Statistical methods such as the simple average and the modal value will be applied for the determination of the amount.

## 6. CONCLUSIONS

There are a variety of techniques to perform the determination on presumptive basis; through regulations, the tax administration seeks constant improvement of both internal and external processes. Regulating the application of the Presumptive Basis is a significant progress in what refers to the determination processes which must be constantly updated.

Similarly, since the Normative Directory Resolution which regulates the presumptive Basis was implemented four months ago, a follow-up must be performed in order to know the positive or negative judicial decisions which could affect this regulation.

In order to have more information to improve the determination, both on real basis and on presumptive basis, it has been considered to appoint new information agents, such as the unique automotive registry, property rights, Financial Supervision Authority, etc.

*Case Study*

*Topic 2.1*

# REPORTING OF FINANCIAL TRANSACTIONS

**Karina Venier**
Deputy General Directorate
AFIP
(Argentina)

***Contents:*** *I. Introduction.- II. Information systems.- III. Other information systems.- IV. Additional regimes.- V. Use of information.- VI. Experiences.- VII. Final conclusions.*

## I. INTRODUCTION

As an introduction and in order to contextualize this topic it should be noted that in our country financial transactions are carried out, essentially, within two types of markets:

- Money or monetary market and the
- Capital markets.

Operations carried out in these markets are covered by bank secrecy and the secret of the stock market, but in both cases there are exceptions, specifically by law for information requirements carried out by the National Treasury.

These exceptions allow the collection entity to request general or particular information and refer to one or more determined or not individuals or entities, even if they are not under control.

It should be noted that in turn the information that the AFIP receives is covered by the tax secrecy, under the tax procedures law.

On the other hand, it is important to highlight the high level of banking in our financial system, of our economic/commercial operations in general, especially since the entry into force of the law against tax evasion.

This Law states the total/partial amount of payments higher than one thousand pesos ($ 1,000), or their equivalent in foreign currency, that

were not made with deposits in financial institutions, money or bank transfers, checks or certified checks, credit card, purchase or debit card, credit invoice, or other procedures expressly authorized by the Executive branch have no effects between parties or third parties;.

This result in a higher recording of transactions in the financial system, which increases the possibility of obtaining data from existing records and those obtained through the different information systems.

## II. INFORMATION SYSTEMS

In our country we have different information systems established by legislation, through which it is possible to collect data that will enable the verification of the collection capacity declared by the taxpayer and will serve as a prevention and detection tool against tax evasion.

The collected information databases from the different agencies perform all types of crosses in order to enable and assist the effective control and fulfillment of tax obligations.
The information systems of financial activity are grouped in a single regulatory body[1], also incorporating mandatory information concerning operations with derived instruments and/or contracts.

### Information System of relevant economic transactions

The most important information regime that we have is the SITER: "Information System of relevant economic transactions" which has the obligation to provide this information about subjects bound to the regime: financial institutions[2], brokers and open market agents.

Financial institutions are required to inform this administration regarding the following operations:

- High, low, and modifications for each calendar month, on current accounts, savings, and open special current accounts (legal entities) according to the regulations of the Central Bank of the Republic of Argentina[3], located in the country.
- Total amount of monthly accreditations n these accounts, in Argentinian or foreign currency (equal or greater than $10,000).
- Balances of the accounts mentioned above (over $10,000) [4]

1 *Implemented through General Resolution 3421, published in Official Gazette on December 26, 2012, ordering in its first articles the repeal of the rules available to various information systems.*
2 *Financial Institutions, only those covered by the Law 21526, as amended.*
3 *Comunicación "A" 3250 del Banco Central de la República Argentina.*
4 *Respecto de este punto, se exige que al último día hábil del periodo mensual informado*

- Consumption with debit cards in the country when the accumulated amounts exceed the monthly amount of $3,000 in each account.
- Consumption of debit card abroad made by holders and/or additional holders.

From these reported operations, the following data are obtained:

As per the financial institutions operations, regarding the payroll, current accounts, savings and special accounts for legal entities:

- Type and account number.
- Standard bank key (C.B.U.)
- Number of members and status of the reported account

With respect to the nationwide consumption with debit card:

- Number of debit cards.
- Total amount of the consumption.

With respect to the consumption made abroad with debit card:

Number of standard key Bank (C.B.U.) of the bank account.

- Number of tax identification number (C.U.I.T), labor identification number (C.U.I.L) or identification key (C.D.I.) of the account holder(s).
- Transaction date.
- ·Identification of the country where the consumption took place.
- Amount of the operation in pesos.
- Name of the business.
- Category code.

With respect to fixed terms:

- Data of the co-owners.
- Type of fixed-term and number.
- Incorporation date.
- Expiration date.
- Amount of the fixed term.
- Type of currency.

With respect to the subjects involved in the operations

*superen en el mes, en valores absolutos los $10.000, considerándose también los importes positivos y negativos.*

The data shown below are reported:

- Surname(s) and name(s), corporate name, or name of the owner (s) or individuals involved in operations and if they are resident in the country or not.
- Full legal address (Street, number, floor, Office, Department, local, city, province and postal code).
- In case of any of the above mentioned, all should have registered the tax identification number (C.U.I.T).

For this purpose, entities and the responsible ones shall have a tax identification number (C.U.I.T) through the Agency´s website, according to the regulations in force.

In the case of **non-resident individuals** : surname and name, document of identity or passport, current address abroad, place and date of birth, tax ID number in the country of residence (NIF), tax residence. In the case of legal entities and other entities: company name or name, type of entity, current address abroad, place and date of incorporation, tax ID number in the country of residence (NIF), tax fiscal residence.

The detail of the aforementioned information is based on the use of various applications programs through which taxpayers enter information and generate the corresponding affidavit in support to send to the Agency.

In the case of the SITER, they are:

- "AFIP - informative system of relevant economic transactions (SITER) - accounts/transactions"[5]
- "AFIP DGI - debit card operations abroad"[6].-.
- "AFIP - informative system of relevant economic transactions - domiciles"[7]

At the same time, open market and Exchange agents must report the purchases and sales carried out on their own or by third-parties, as well as public titles or private securities traded in the country.

For such purposes the following are considered:

5 *Form de DDJJ AFIP - REGIMEN INFORMATIVO DE TRANSACCIONES ECONOMICAS RELEVANTES - CUENTAS/OPERACIONES, Versión 1.0 : F. 943.*

6 *Versión 1.0", generated by the affidavit Nº 8103.*

7 *Versión 1.0", generated by the affidavit Nº 944.*

- Own Operations: Those agreed by brokers and open market for them
- Operations on behalf of third parties: are those agreed by the brokers and open market in compliance with instructions or orders of their clients or customers.

This include transactions made by the brokers for their stock companies, no-agents partners, Trustees, administrators, managers, employees and subsidiaries; as well as those made by the stock and non-stock societies for their directors, Trustees, administrators, managers, employees and controlling and/or controlled companies.

They should report on a monthly basis a summary of operations and their net amount, except for those purchases and sales, indicating the payment form (Commission or price differential). Those caused by "trading" operations and financial derivatives should also be identified.

This means that:

- "Trading operations", are those involving the purchase and sale - both operations, in that order, or in the opposite direction - from the same client or customer, and the same amount of titles of a species with identical dates for conciliation and settlement.
- "Financial derivatives" operations are those concerning contracts of futures and options traded on stock exchange and out of the stock exchange. Also refers to operations with options to reach both the negotiation of premiums and an eventual transfer of the underlying asset.
- Net amount of all transactions carried out by each holder, during the course of each reported calendar month. To this end should be considered the date of liquidation of the operation and the following cardholder operations data, as well as their purchases and sales.

The data from this information are:

- Surnames and names, business name or denomination.
- Full legal address (Street, number, floor, Office, Department, local, sector, Tower, Apple, town, province and postal code).
- Registered holders at the Federal Administration: key tax identification (C.U.I.T).
- In the case of individuals not registered at the Federal Administration: Labor identification Code (C.U.I.L) or identification key (C.D.I.), as applicable.

In addition, in case of **non-resident** individuals: surname and name, document of identity or passport, current address abroad, place and date of birth, tax ID number in the country of residence (NIF), tax residence. In the case of legal entities and other entities: company name or name, type of entity, current address of abroad, place and date of incorporation, tax ID number in the country of residence (NIF), tax fiscal residence.

The total net amounts of operations carried out by the holders thereof, during the reporting period, except for - per client account - amounts corresponding to purchases and sales, indicating the mode of remuneration (Commission or price differential) and identifying transactions that correspond to "trading" and financial derivatives operations.

In the case of **operations with public and private securities values** in foreign currency, the information agent must convert them to their legal tender currency equivalent, taking into account the exchange rate buyer, in accordance with that last quote for the currency established by the Banco de la Nación Argentina, corresponding to the established date.

This is monthly reporting duty.

In order to generate the relevant information as well as to prepare the returns, the application program called "AFIP DGI - public and private values, brokers and open market [8] is available.

## III. OTHER INFORMATION SYSTEMS

On the other hand, we can mention other information regimes from which data relating to financial transactions and information that contribute to the generation of data Bases and information available to Computer crossings is obtained, namely:

- **Foreign exchange transactions**

Authorized entities by the BCRA (Central Bank of the Republic of Argentina) are required to operate in exchanges.

8 *Aplicativo Versión 3.0. Capítulo B.-*

It includes sale operations in foreign currency - currency or banknotes - made by authorized institutions, in all their forms and whatever their purpose or destination, and purchase of foreign currency transactions as a result of re-entry of the funds under the specific regulations[9].

They shall register - only for tax purposes-, the total amount in pesos for each of the above-mentioned foreign exchange transactions, at the moment in which they are carried out.

For these purposes, the exchange of information through an institutional web service of this Federal Administration and/or for the service called "consultation of Exchange operations" on the same site.

Within the framework of a specific agreement for the exchange of information between the Federal Administration of public revenues and the Central Bank of the Republic of Argentina (BCRA)[10], it is possible to also get information from entities that operate in "exchange", which are required to report transactions made by their customers in the single market and free of change (MULC) with their intervention.

This information is sent by the Central Bank, at the request of this administration and is used for analysis, fragmentation according to different levels or sectors of taxpayers, and for research.

Hereinafter it will be referred to the types of crosses and results as part of the investigation and that trigger the later process of taxpayers control, in case irregularities or inconsistencies are detected.

- **Operations of purchase and discounts through endorsement or assignment of documents**

In this scheme financial institutions in particular, are required to submit information when they act as assignors or receivers. They do it on a monthly basis and for each operation, reporting: data of the negotiated documents collector (assignor, administrator or designated collector agent), surname and names, business name or denomination, domicile. If they are non-resident subjects, the same data than the residents, the tax ID number in the country of residence (NIF) and tax residence.

9 *Se hace referencia al inciso a) del punto 3.2. de la Comunicación "A" 5330 del Banco Central de la República Argentina, y las que en el futuro la reemplacen, modifiquen o complementen.*

10 *Comunicación "A" 3840 - Banco Central de la República Argentina y Comunicación □A□ 5330.*

The type of negotiated document or type of operation performed by the assignor or transferor regarding liability to payment of the amount of the transferred credit, total amount of the negotiated document and date (s) of expiration/s, amount of the interests of funding included in the negotiated documents are also reported.

For the transmission of information from this regime, those responsible must generate and send the return through the application "AFIP DGI- operations of purchase and discount by endorsement or assignment of documents".

- **Foreign Income reported by residents in the country:**

In this regime the subjects bound to report are individuals and legal entities, residents such as contractors through intermediary of financial institutions and other entities, and anyone entering funds into country directly, or owners of the funds when they act through any entity or non-resident person, enter directly or, where appropriate order the entry of funds through financial institutions.

Operations corresponding to purchases of change in concept of capital are included, which for the purposes of the present regime have origin in concepts such as: contributions of direct investments in the country; Loans from international agencies; Official agencies of credit loans; Loans guaranteed by official credit agencies; Financial loans; Sales of stakes in local companies to direct investors; Collections of financial loans granted to non-residents; Repatriation of investments of residents; Financial guarantees; Other investments in the country by non-residents; among others.

The detailed information include: the description of the origin of the funds, date of entry and operation originating funds, currency, amount entered in national or foreign currency import operation originating the entry of currency, financial institution intervening, key tax identification (C.U.I.T) of the involved financial institution. Country where are the funds are generated or transferred.

To transmit the information to the Agency, it is necessary to use the application "AFIP DGI - regime information of market exchange" system, to generate the corresponding return and send the information according to the legislation in force.

- **Institutions administering credit cards**

This regime requires the managers of credit card systems to report sellers, landlords, and/or service providers attached to the referral system, the operations - sales of assets, locations of works and locations or performance of services carried out by the aforementioned subjects, which have been cancelled through the use of credit, purchase and/or debit cards and credit or purchasing cards issued in the country and abroad.

These entities have to send monthly the information provided for each of the following concepts:

Sellers, landlord, and/or service providers adhering to credit card systems. Tax identification number (C.U.I.T). Category code. Tax identification (C.U.I.T) of the Financial Institution. Mode of payment: Bank transfer: key Bank (C.B.U.), branch office, type and number of the subject informed bank account. Other modality. Operations sales of goods, works and locations or services locations. The total amounts of the operations performed by the subjects listed above, which have been cancelled through the use of credit, purchase and/or debit cards. Purchase and credit cards issued in the country and their owners (surname and names, company name or name; type and document number card number; amount of extended additional cards); among others.

For the transmission of information from this regime, the managers must generate and send the affidavit through the application "AFIP DGI-credit cards".

- **Operations with instruments and/or derivatives contracts**

This regime applies for certain taxpayers who are taxed on profits, (excluding banks), with respect to operations that they perform with instruments or derivatives contracts.

The information to provide is related to the initial planning of the operation, modification of the original contract or concerted operation, partial and total liquidation, early termination. With respect to each of them, all available information has to be provided.

The registration obligation is carried out through electronic transfer of data, through the website of the entity.

In addition, a file in a particular format, with the digital version of the document that backs the operation in question shall be attached. If the transmission is accepted, the system emits an acknowledgement voucher.

They are also required to report the coverage instruments and/or derivatives contracts operations, when they seek to reduce the effect of future fluctuations in prices or market rates on the outcomes of the major economic activities, i.e., when the profile of the possible outcomes of an instrument or derivative contract or a combination of them is to compensate possible emerging outcomes of the risk position for the taxpayer in the respective transactions; has direct links with the taxpayer's main economic activities as well as the underlying element which also relates to the aforementioned activities; whether it is quantitative and temporarily according to the risk that it is intended to cover - totally or partially - and that in no case exceed it.

To transmit this information to the TA, a service (with tax key) is available on the web site of in which policy-makers must enter the required data: "Registration of operations with instruments and/or or derivatives contracts"-

- **Operations of non-resident subjects through local financial institutions**

Financial institutions must inform operations carried out by non-resident subjects in the country, through the above-mentioned entities.

Operations in the scope of the present regime are:

- Earnings, profits, and enrichments paid to non-resident subjects through these institutions, whatever their nature.

- Placements, investments or holdings of these subjects in the mentioned entities.

The detail of information and involved subjects is similar to the arrangements previously mentioned, and we refer briefly to them.

For this purpose, a program application called "AFIP DGI – INFORMATION SYSTEM FOR NONRESIDENTS OPERATIONS".-

## IV. ADDITIONAL REGIMES:

Then we will mention other regimes and/or sources of information that although they do not directly relate to the financial operation, complement the information necessary for the investigation, and integrate the computer crossings, collaborating with the construction of the economic reality of taxpayers.

- **Regime beneficiaries from abroad**

Under the world income principle that governs our legislation, of foreign societies, companies, individuals or any other subject who are not resident in the Republic of Argentina and earning income from Argentinian source (either abroad or in the country), directly or through representatives, agents, representatives, or any other representative in the country, are considered beneficiaries.

Therefore, these beneficiaries from abroad, when receiving income, are requested to pay the tax on earnings.
In order to optimize the perception of tax, a withholding regime at source has been established, (SICORE) corresponding to the subjects who pay this rent, to withhold and enter the tax to the Treasury and not the beneficiary.

Therefore a procedure called Withholding Control System (SICORE) has to be followed by agents appointed for the purpose of reporting and entering the withholdings or practiced perceptions, according to tax legislation.

In this system, those responsible for reporting withholdings and/or perceptions do it in on a monthly base, and enter the balance resulting from the affidavit.

Also among other items are reported the data of the subjects involved, the date of operation, description of operation code (this is for example: interest on operations in financial institutions, payment of royalties ;) Debt interests, including those of obligations; Users of the credit card system; Interests paid for credits earned abroad; International transport, chartering - operations with containers; Interest and commissions on loans granted by financial institutions; Imports, etc.).

With this information in conjunction with other information systems, provided by taxpayers and arising from the databases, it is possible to obtain relevant information.

- **AFFIDAVITS - tax profits and on personal property.**

The Affidavits are prepared by taxpayers and responsible, according to their category or types of income, through which they pay, determine the taxable base, either provides the information requested by the AT, according to its powers of oversight and control.

These statements received by the Agency, are an important source of information.

Therefrom, and other elements, it is possible to check the effective fulfillment of the tax obligations and verify the consistency of the reported data.

Information that complements the data Bases of the Agency is also obtained from them and they constitute an informative regime themselves, since they identify, all the assets and liabilities of the taxpayer, for example, enabling the reconciliation of balances declared by operations between different taxpayers, in terms of credits and debts, among many other topics.

Through the verification of the data reported by the taxpayer in his affidavits (tax on profits - personal assets, among others), with respect to the movements in accounts, banking credentials, foreign bank transfers, purchase and sale or possession of shares or securities, among other data, it is possible to detect inconsistencies or omissions that will be analyzed in depth by inspectors.

- **Tax debits and credits in checking account**

Our tax legislation has a tax to apply on credits and debits in current account, for operations by financial institutions when their contractors or beneficiaries do not use the listed accounts, (whatever the name given to the operation); and all movements of equity, or third parties, even cash, to anyone, including financial institutions, perform on their own account or on behalf of others.

The same instrumentation establishes the obligation to liquidate, enter and inform the perceived tax amount returned to certain subjects:

- As liquidation and perception gents: financial institutions and subjects performing fund transfers or delivery payable to or on behalf of another person.

- For their own tax : financial institutions and subjects performing movements or deliveries of funds in their own name, as well as those who must enter, wholly or partly, directly the omitted tax.

Specifically information agents are financial institutions and those performing movements or delivery of funds payable to or on behalf of another person.

Such information should be sent on a monthly basis.

Both for the transmission of the information required for the generation of the respective affidavit, the application program named "CREDEB - VERSION 1.0" is used for the control of these obligations and also as a source of information for the Agency.

- **Information system for companies**

This information system orders certain subjects[11] to provide information regarding individuals and inheritances - domiciled or located in the country and abroad - which at the end of each year are holders or have shares or social equity (securities, stocks private - including scriptural actions-, shares and other participation certificates, parts of the mutual investment funds); companies, patrimony of affectation or holdings domiciled, stable establishments, living or located abroad, at the end of each year are holders or have the participation to the above mentioned; and other subjects that have participation in social capital or equivalent, as well as of the directors, managers, administrators, trustees and members of the Board of Trustees.

This regime facilitates the structuring of systems, procedures and plans to optimize the audit and control of tax obligations.

## V. USE OF INFORMATION

Through the above regimes, such information allows us to enrich the databases that constitute a fundamental tool in control process.

In this regard, the inspection process can be divided into two operational stages:

- A so-called "investigation", which involves the detection of inconsistencies, and/or omissions, through crosses of affidavits

*11 Sujetos obligados: RG 4120/99: Los establecidos en el artículo 49 inc. a) y b) - excepto las empresas unipersonales y las sociedades cooperativas - de la Ley de Impuesto a las Ganancias, texto ordenado en 1997 y sus modificaciones.*

filed by taxpayers and the information provided by the regimes of information, among other information contained in our database.

This stage aims to determine which taxpayers will be audited under the inconsistencies detected.

- And a second, "Control" that will aim to prior verification of the evidence provided by the taxpayer to determine the correct amount of the tax and start the processes aimed at debt recovery (acceptance of the determination by the taxpayer and/or initiation of the procedure for the automatic determination).

Among the investigative tasks, the following can be highlighted:

- Reconciliation between bank balances and accounting.
- Analysis of the movements registered in bank accounts abroad, paying special attention to the origin of the accreditations.
- Verify that checks of third parties, both received as delivered as part of payment, originate from the company operations.
- Verify the fulfillment of the law against tax evasion (law 25.345), with regard to ways and means of payment.
- Verify if there are bank accounts not declared from the payments cancelled with own signature checks.
- Apply and analyze particular accounts of the partners in order to assess the existence of funds available.
- Check if there were import operations with related or companies based in countries of low or zero taxation and verify their correct treatment.
- Examine whether operations were carried out with companies based in countries that held a Convention to avoid double taxation and in his case note its appropriate treatment.
- Confirm the most significant balances with supporting documentation, as appropriate (loans, agreements on current accounts, etc.).
- Verify the income and/or the deposit of funds.
- Track paychecks delayed to the end of the year, in the following year.
- If there are loans from institutions abroad, analysis of contracts, minutes of Assembly or directory where the need for borrowing was stated, conditions agreed, form of entry into the country of foreign currency, etc.

From the hypotheses of the analysis and information crossings obtained through information systems, the following can be detected:

1 – Not justified economic increases: originated in the detection of:

- Omission or error in balances of bank accounts.
- Shareholding interests or other securities holding values not reported.
  (Bonds, Government securities, participation in mutual funds, trusts etc)
- Existence of undeclared properties, or purchase prices lower than the notarized values.
- Non-existence of liabilities.

2 Omitted income detected from the comparison of banking credentials, movements of cash, buying and/or selling of currency, over the declared income.

3 Defaults to the law against tax evasion and omission of tax debits and bank loans, by the use of means of payment not enabled (consequences with the impossibility of an expense deduction and the computation of tax credits).

4 Omission of withholdings to beneficiaries from abroad, through the crossing of the returns presented and information about liquidation of foreign currency provided by the BCRA.

5 Detection of cases of triangulation of imports or exports, operations with countries of low or null taxation, through the use of the liquidations of change information.

6 Erosion of the tax base through the use of derivative contracts.

7 Omission of foreign source income. Through the intersection of information exchange with the income returns from foreign sources, useful for the control of those results in countries where there is no Exchange of information agreement.

8 Exchange breaches, with regard to the legislation in force.

## VI. EXPERIENCES

We can mention some of the experiences obtained from the use of data from the reporting of financial transaction.

- **"Cash" operations (“contado con liqui”):**

"Cash operations" are financial practices used in the local market to avoid the use of the Single market and Free Currency Exchange (hereinafter: MULC).

Thus, subjects using this mechanism are in dollars abroad - or pesos in the country, according to the convenience of the moment-, without passing through the respective controls or the applicable exchange requirements.

They perform almost simultaneous transactions of buying and selling of Government securities (which have trading in pesos and in dollars, e.g. Discount) from which they try to justify the movements of funds.

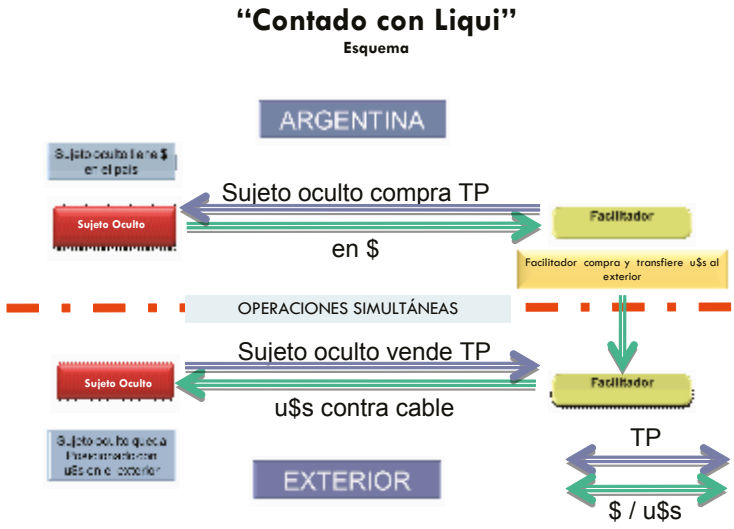
If the intention is to send foreign currency (dollars) out of the country, the next operation follows the scheme described below:

Through one or more stock exchange companies, a subject ("hidden", from the exchange control) appears buying such securities in pesos and selling them almost simultaneously in dollars (received abroad). This requires other subject/s ("facilitator/s") that makes the inverse operation, i.e. they sell values and purchase them against dollars. These last subjects facilitate the operations of the first ones, getting a positive result, which represents the cost assumed by the first, to be positioned in dollars abroad, without going through the current controls.

The subjects facilitating operations in general are individuals linked to stock market companies, given that this way they expand their scale of business, due to the limitation of u$ s 2 million per month per subject to form external assets (buying dollars in the country). These subjects are exposed to the MULC control for buying dollars and transferring them abroad.

Through the information regime of relevant economic transactions (SITER - operations with government securities) taxpayers that record transactions of purchase and sale of values that might fit into the cash operation by amounts can be observed.

Recently a criminal complaint has been made when it was detected that through this operation, non-operational companies are used to send dollars abroad, hiding the real owner of the funds.-




- **Derivatives contracts**

Through the information provided by the BCRA, taxpayers who transferred currency abroad under the description of "derivatives contracts", when such qualifications did not correspond to the real economic intention of the parties were detected

Once these contracts were analyze it was observed that they intended to increase the interest of a loan obtained abroad.
In our legislation, the results obtained by a subject abroad over loans to our country, are not included in income tax, so they were eluding the beneficiary withholding income from abroad for currency remittances.

Given the economic reality of the transaction, an adjustment was determined in order to tax the money transfer as interest on the loan subject to the withholding tax on profits.

In this analysis the information system SICORE (System of Control of retention) were also used – withholding of profits for interest paid on borrowing abroad and regime of beneficiaries from abroad, among others.-

## VII. FINAL CONCLUSIONS

We can conclude that the computerization of information and increased registration of commercial and financial operations to optimize the inconsistencies detection methods for the payment of taxes in general as well as omissions of taxpayers and tax responsible are very important issues.

The use of the information systems on financial transactions as well as various exchange of information agreements with other agencies such as the Central Bank, have increased the level of analysis and control of operations and have also contributed in the fight against evasion and laundering of assets of criminal origin.

We believe that the path forwards is to continue improving these information systems, generating greater risk perception by, optimize the time of the audits and inspections and detect detours or omissions more effectively.

It is our commitment, to continue providing more and better technologies and keeps training the staff at the height of the demands that both the commercial, financial, exchange rate and international operation represent in this everyday more complex globalized world globalized world.

*Case Study*

*Topic 2.1*

# REPORTING OF FINANCIAL TRANSACTIONS

**Flávio Araujo**
General Coordinator of International Relations
Secretariat of Federal Revenues
(Brazil)

***Contents:*** *1. Introduction.- 2. CPMF .- 3 Complementary law No. 105, January 10, 2001.- 4. Convention on exchange of tax information between Brazil and the United States .- 5. FATCA (Foreign Account Tax Compliance Act)*

*Presentation PPT*

## 1. INTRODUCTION

The Internal Revenue Service of Brazil (RFB), is the agency responsible for the Brazilian tax administration, for more than a decade it has control mechanisms for collecting and controlling federal taxes, through access to information about financial units of their taxpayers.

The RFB access to information on financial transactions is an important control instrument, since it allows verifying that the amounts in the financial institutions are compatible with the declared income of each accountholder.

In 1996 the Provisional Contribution on Financial Transactions (CPMF) was created, which calculation basis included banking movements, making possible to indirectly verify the amounts deposited by accountholders in financial institutions.

The CPMF captured information about the financial movements of a broad base of taxpayers, of debits made from their respective current accounts, savings and loans, both from individuals and companies. The scope of the information obtained from taxes not only included legal operations, but also those from money laundering and resources not accounted in the companies.

With the complementary law No. 105 of January 10, 2001 (LC 105) financial institutions began to inform the tax administration of financial transactions made by their customers, giving the Treasury an important tool with which it is possible to make the crossing of information obtained from various sources.

## 2. CPMF

The Provisional Contribution on Financial Transactions (CPMF) focused on the majority of banking operations. The power of the CPMF in stock market operations, pensions, unemployment insurance, wages and transfers between checking accounts of the same accountholder were an exception.

The CPMF was approved in 1993 and entered into force the following year under the name IPMF (Provisional tax on financial movements) at that time, the rate was 0.25% and so it remained until December 1994 when, as planned, it became extinct.

Two years later, in 1996, the Government discussed the matter again with the intention of directing the collection of this tax to the health sector. It was then when in fact the CPMF was created, which entered into force in 1997 with a rate of 0.2%.

In June 1999, the CPMF was extended until the year 2002, with a rate of 0.38% its major objective was to help Social security accounts.

At the end of 2000, the crossing of banking information with the income tax returns of taxpayers (IT) was allowed. Thus, cases of taxpayers that were declared exempt from this IT but at the same time, had moved large amounts in their bank account, have been identified by the Treasury through the CPMF payment information.

In 2001, the rate was reduced to 0.3%, but in March of the same year, it returned to 0.38%. In 2002, the CPM was extended, which happened again in 2004.

In 2007 the Federal Government attempt to once again extend the payment of this contribution was frustrated, as the proposed constitutional amendment was not approved in the Senate.

Finally, in January 2008, the CPMF was not charged to Brazilians, causing a fall in revenues of $40 billion in 2008 and the end of an effective instrument to fight tax evasion and financial crime.

## 3. COMPLEMENTARY LAW NO. 105, JANUARY 10, 2001

The complementary law No. 105, January 10, 2001 (LC 105), widened the tax administration´s investigation power, since it gave access to various types of banking operations performed by account holders.

According to article 5 of the LC 105, financial institutions have the duty to inform the Treasury about the operations performed by users of its services. Paragraph 1 of the article has an extensive list of features of those operations that are considered "financial operations" in order to provide the respective information. In addition, according to paragraph 2 of the same article, data on global monthly amounts movements should be limited to holders of the operations, without the insertion of any element that can identify the source or nature of these expenses.

However, once signs of faults, inaccuracies, omissions, or commission of an unlawful tax are detected, the respective authority may request the required information and documents, as well as perform a control or audit for the proper verification of the facts, as established in paragraph 4.

Paragraph 5 establishes that the information displayed on the screen must be confidential, i.e. have tax secrecy, according to the legislation which governs it.

Article 6 of the LC 105 sets two conditions to enable administrative authorities to examine documents, books and records of financial institutions, including those relating to accounts deposits and investments of taxpayers with regard to taxes including: the existence of an administrative process or fiscal procedure in process and the fact that such examinations are considered necessary by the competent administrative authority for the development of a fiscal action.

In addition, according to the first paragraph of art. 6, the results of these examinations, the data and documents mentioned in this article should be kept confidential, according to the tax legislation.

LC 105 authorized the Executive Branch to define criteria on which financial institutions shall inform the tax administration about the financial transactions performed by users of its services, including the frequency and amounts limits

The LC 105 defines the set of financial transactions likely to be reported to the Tax Administration:

(a) Deposits and term deposits, including savings accounts;
(b) Payments in cash or checks;
(c) Orders of credit or similar documents;
(d) Refunds in deposit accounts or term deposits, including savings;
(e) Mutual contracts;
(f) Discount of duplicates, promissory notes and other debt instruments;
(g) Acquisitions and sales of fixed or variable income securities;
(h) Applications in investment funds;
(i) purchases of foreign currency;
(j) Foreign currency conversions into national currency;
(k) The transfer of currency and other securities abroad;
(l) Operations with gold, financial assets;
(m) Operations with credit card; and
(n) Leasing operations;

Based on the precepts contained in LC 105 in 2003 the Federal Revenue created the Statement of Credit Card Operations (Decred), to be submitted by credit card companies, identifying the users of their services and the amounts of resources.

The Decred contains information related to the holders of the credit card, and of accredited commercial establishments to operate them.

Respondents send to Federal Revenue the information on those accounts that had a monthly amount movement higher than the five thousand reais limit (R$ 5,000.00) for individuals and ten thousand reais (R$ 10,000.00) for legal entities.

This way, the Treasury has an important tool to verify that the expenses incurred by the taxpayer in credit card are compatible with their declared income, in addition to double-check the Decred data with other internal sources of information.

The above mentioned Statement also receives information concerning commercial establishments with sales through credit card.

After the Government defeat in the case of the CPMF in late 2007, it had to take measures to continue having access to the taxpayers' financial movements. The measure came through a new obligation imposed to financial institutions, through the RFB regulation No. 811, 2008, which created the Declaration of information on financial movements (Dimof).

The Dimof is mandatory for any Bank, credit unions, and savings and loan associations. Through the financial institutions the information on financial transactions carried out by the users of their services in the deposit account or savings account, referring to deposits and term deposits; payments in cash or checks; issuance of credit or documents such as orders and refunds in cash or term will be provided.

The financial institutions must provide information in relation to the holders of operations, the total amount of transactions per semester if it exceeds the five thousand reais limit (R$ 5,000.00) for individuals and ten thousand reais (R$ 10,000.00) for legal entities.

The Dimof receives information about the monthly global amounts moved, being prohibited the inclusion of anything that makes possible to identify the origin or the destination of the resources used in financial transactions.

The received data are crossed with the information provided by the Federal Revenue in order to select taxpayers who show evidence of fiscal irregularities. Then the tax authority establishes a control process and invites the taxpayer to provide details on the differences. When the taxpayer refuses to submit the information or documentation requested, the tax authority may order the financial institutions to provide them with the details of financial operations carried out by the taxpayer.

Currently, the Supreme Court of Justice (STF) is discussing within the constitution framework, the LC 105, referring to the provision of information directly to the tax authorities on the banking movement of taxpayers to financial institutions, by means of an administrative procedure, without prior judicial authorization.

The thesis on the unconstitutionality of LC 105 is based on providing information directly to the tax authorities on financial movements without judicial authorization, which could constitute a violation of the taxpayer confidentiality that would be against constitutional principles that guarantee the inviolability and secrecy of the taxpayers' data.

## 4. CONVENTION ON EXCHANGE OF TAX INFORMATION BETWEEN BRAZIL AND THE UNITED STATES

On March 7, 2013, the Federal Senate of Brazil approved the agreement for the exchange of tax information (TIEA), signed between Brazil and the United States on March 20, 2007. This way the examination and approval of the TIEA by the National Congress was concluded.

These agreements for the exchange of tax information, which has been intensified by the country in recent years, are essential in the fight against fraud and tax evasion and abusive or aggressive tax planning, preventing the erosion of the tax base of the country. They are also valuable tools in the fight against the organized crime and money-laundering.

The orientation adopted by Brazil, not only reflects their greater participation in the efforts of the Group of the 20 richest countries (G20) in the fight against “tax havens", but also follows the global trend of a greater collaboration between the countries administration in the field of taxation, especially by accompanying the globalization of business and the mobility of capital, people and services.

One of the consequences of this participation was Brazil´s adhesion, on November 3, to the "Mutual Administrative Assistance in Tax Matters Convention" ("Multilateral Convention"), in the section concerning the exchange of information, which already counts with the participation of some 50 countries.

Specifically, the TIEA signed with United States includes in the case of Brazil, the following taxes: income tax of legal entities and individuals (income tax and personal income tax, respectively), Social contribution on net profits (CSLL), tax on industrialized products (IPI), tax on financial operations (IOF), tax on rural Territorial property (ITR), contribution to the Social integration program (PIS) and the Social contribution for the financing of the Social Security (Cofins).

The TIEA not only provides for the possibility to exchange information, but also to expand the possibility for cooperation between tax administrations regarding control practices, respecting their national laws. It also deals with the costs involved in compliance with requests from the other party and, in line with the positions adopted in the tax agreements, which have strict rules to protect the confidentiality of the information provided.

It also foresees situations where the information requested may be refused and the mechanism for the friendly resolution of problems that may arise in their application.

Finally, the TIEA serves not only the interests of the respective tax administrations, but also strictly observes the rights and guarantees of taxpayers.

In addition to the TIEA and Multilateral convention with United States, Brazil has recently signed agreements with the same purpose with the United Kingdom and Uruguay. At the same time, the provisions for the exchange of information agreements have been updated to avoid double taxation (ADT) which envisages the possibility for banking information exchange.

## 5. FATCA (FOREIGN ACCOUNT TAX COMPLIANCE ACT)

Enacted in 2010 in order to reduce the tax evasion in the United States and comply with the U.S. tax laws, the foreign accounts have been widely debated in the context of the global financial market.

The law requests financial institutions around the world to handle and report to the US tax authorities, information about financial transactions of US citizens, businesses and corporations that are residents or work outside the country.

This measure not only determines the collection and transmission of information on financial transactions to the US tax authorities, such as the application of sanctions to customers who refused to authorize such procedures. The penalty for noncomplying is 30% of any payment to be made to the depositor or investor, the financial institution that does not adhere to the agreement, or adheres but does not correctly report the information, shall be subject to the 30% withholding on receivable payments from the original US source.

The legislation not only includes banks, but all institutions that accept deposits, maintain financial assets on behalf of others (such as custodians and clearing houses) or have investment, securities or equity as main activity.

The Treasury Department of the United States is encouraging countries to sign bilateral agreements for the exchange of tax information required by the FATCA. In return, it offers reciprocity. i.e., through these agreements, the Treasury of the United States receives information concerning U.S. citizens and send to the signatory country banking information regarding their citizens.

# TOPIC 3

# TAX AUDITS: MARKET SEGMENT SPECIALIZATION PROGRAMS

*Lecture*

*Topic 3*

# TAX AUDITS: MARKET SEGMENT SPECIALIZATION PROGRAMS

**Pancrasius Nyaga**
Commissioner of Domestic
Taxes-Large Taxpayers Office
Kenya Revenue Authority
(Kenya)



## 1. OVERVIEW

The Kenya government to a very large extent relies on tax revenues to finance its budget. The tax revenue target is increased by a huge percentage every year. This puts a lot of pressure on Kenya Revenue Authority (KRA) to deliver on its mandate of tax collection. The immense pressure is against a backdrop of great efforts by businesses to manage their tax affairs in order to improve their bottom line.

As a result of the high revenue expectation, KRA has resulted to being more innovative in its various programs which include audit, compliance, taxpayers services and policy. KRA's mission is to be a leading revenue authority in the world, respected for professionalism and fairness. The Agency has approximately 5,000 employees.

### Background information

KRA is the main collection agent for the Kenya government revenue accounting for over 96% ordinary revenues. The Authority administers 18 Acts of Parliament and also collects agency revenue for several Government Agencies. The main revenue collections are from domestic taxes and customs duties.

The Domestic Taxes Department (DTD) accounts for approximately 70% of the total revenue collected by KRA. During the fiscal year

ended June 2013, DTD collected Kshs.541 Billion (US$7 billion) or 70% of the total tax revenue. Taxes collected from audit activities account for approximately 4% of the domestic taxes collection[1]. The 30% balance of tax collection is by Customs Services Department.

There are many factors that act as show stoppers towards meeting of the annual set target and these include tax evasion and avoidance, tax planning, tax exemptions and remissions granted by the government, poor economic performance, unfavourable tax legislation, etc.

To meet the many challenges associated with finite resources and the expectations of improved performance relating to collections or revenue generation, the administration has embarked on a business transformation agenda that is rooted in business solutions and technology applications. To this end, the integrated tax management system (iTax) project that was initiated in 2009 is expected to deliver new business solutions that allow online filing of tax returns and payment of taxes, providing data for research and analysis and risk assessment. These when combined will enable a flexible risk-based approach to audit and compliance management. The information system enhancements will allow the tax administration to make more efficient use of finite financial and human resources with the goal of improving audit yields and compliance results.

The Kenyan tax administration has also been able to use international administrative cooperation in tackling tax evasion and avoidance through transfer pricing arrangements. To this end the country has entered into several double taxation agreements (DTA's) and is also a member of the Global Forum for the Exchange of Information for tax purposes. There has also been legislation of laws to allow for Tax Information Exchange Agreements (TIEAs).

KRA audit operation program has made significant improvements to its activities in recent years in order to address the emerging risks and to improve efficiency.

1 *Kra business analysis unit 2012/2013*

## 2. ORGANIZATION AND MANAGEMENT OF THE AUDIT FUNCTION

To achieve efficiency and effectiveness, KRA has divided its DTD operations into two departments;

a) Large Taxpayers Office (LTO)

b) Medium and Small Taxpayers (MST)-incorporating Medium Taxpayers Office (MTO) as a mirror image of LTO

The MST comprise of entities whose turnovers do not exceed specified threshold and include sole proprietors, partnerships, trusts, and corporations They also include individual filers who have employment and other incomes.

Banks and financial institutions, government agencies, Insurance and Oil Exploration Companies are all under the LTO irrespective of their turnover thresh hold. In addition to taxpayers in these sectors, other taxpayers in LTO are those from other sectors, but whose turnover thresh hold is above that of taxpayers qualifying under MST.

The two departments share an audit Policy Unit which monitors the standards and quality of the audits.

KRA has further segmented the taxpayers within LTO into the following sectors;

1 Top 25
2 Banks & Insurance
3. Manufacturers-Food & Others
4. Domestic Excise
5. Transport, Petroleum and Motor vehicles
6. Agriculture and wholesalers
7. Government & Construction
8. Mining & Petroleum Exploration & Gas

There are also expert teams in the area of transfer pricing and international transactions and computer aided audits who provide support on audits that have these features.

Based on the above segmentation of taxpayers, a concept of Market Segment Specialization Programs (MSSP) has been developed to focus on developing highly trained examiners for particular market segments. This provides a change in the approach undertaken in audit and compliance activities. Many tax authorities have in the recent past

embraced the concept of MSSP as an audit management tool. The general goal is to organize compliance activity around market segments, where practical. A market segment can be an industry, such as mining, a profession, such as accounting, or an issue such as transfer pricing.

The sophistication and complexity of taxpayers' financial affairs and compliancepractices will usually vary according to the nature and size of their enterprise. For effective implementation of MSSP the tax administration should ensure that the audit staff are provided with information on the segment so that audits are performed in an efficient, effective, and intelligent manner.

KRA's 5th Corporate plan theme is on achieving excellence in revenue administration through organizational renewal, innovation and entrenchment of best practices in performance management, service delivery and the use of technology to improve tax administration processes. In line with this, KRA has laid down strategies to achieve revenue targets through a revamped enforcement strategy, innovative approaches to enhance collection in sectors with low tax compliance and scaling up compliance within the various business sectors

KRA has adopted taxpayer segmentation to organize resources according to industry specializations (e.g. manufacturing, Mining, construction, hospitality, etc). The changes in the taxpayer audit and compliance programs to align the same to specific segments was initiated in 2008 and has been enhanced over the years to create a more robust and focused strategy for each particular segment.

Whilst the establishment of the Large Taxpayers Office (LTO) and medium taxpayers office (MTO) have significantly addressed compliance risk, KRA has found it necessary to go beyond mere structure and aligned strategies with the audit and compliance issues in each particular segment of the taxpayer population. This is done through specific sector risk profiling analysis which provides guidance on the enhancement of the audit case selection process through the use of a scoring and weighting mechanism to allocate points on various indictors to enable the identification to the most risk prone taxpayers. Based on the results, the taxpayers scoring the highest points within the specific segments will be prioritized for audit review.

Ultimately an effective audit and compliance programs require capable staff, versatile information technology infrastructure as well as positive tax paying culture. It is therefore imperative that every tax administration should endeavour to develop staff capacity through training and exposure to best practice, invest in information technology

and put in place a strong taxpayer education program. Although a lot have been done in strengthening the Kenyan tax administration there are still challenges of skill gaps among the technical staff, information technology infrastructure which is still far below best practice standards as well as low compliance levels among taxpayers.

Effective and targeted training to enhance skill capacity, improving on information technology and aggressive taxpayer education will allow the tax administration to make more efficient use of its financial and human resources with the goal of improving collection and compliance results, as well as, more effective audit operation program from a risk and investment perspective

This paper will articulate how the Kenyan tax administration has incorporated the concept of Market Segment Specialization Programs to assist in addressing tax compliance risks through audit initiatives within the Domestic Taxes Department. It will identify the impact the KRA has created through implementation of the audit strategies as it relates to the subject.

The tax audit programme performs a number of important roles including the following;

- **Promote voluntary compliance:** The program seeks to achieve this by reminding taxpayers that those who abuse tax law will be detected and appropriately penalized. This reduces non-compliance and creates confidence in the broader community.

- **Detect non-compliance at the individual taxpayer level:** By concentrating on major areas of risk and those individual taxpayers most likely to be evaders, audits bring to light significant understatements of tax liabilities, and additional tax revenue collections.

- **Gather intelligence:** Information obtained during field audits used for benchmarking and this is subsequently used to counter tax evasion schemes.

- **Educate taxpayers:** Audit program activities also include taxpayer education by clarifying the application of the law for taxpayers and to identify improvements required to record keeping and thus may contribute to improved compliance by taxpayers in the future.

- **Identify areas of the law that require amendment:** audit program also bring out areas of the tax law that are ambiguous thus causing difficulty in compliance. The authority would then make proposals for amendment.

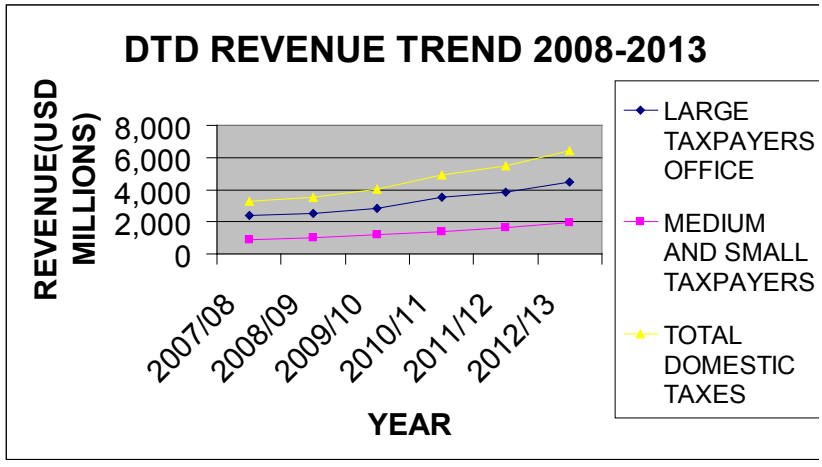
The strategic objective of all the audits undertaken by the administration is to achieve a balance in coverage, quality and deterrence.

## 3. SUPPORT TOOLS FOR EFFECTIVE TAX AUDIT IMPLEMENTATION

KRA has made significant progress in its strategic objective of reducing tax evasion by improving compliance control processes by adopting best practice in all its operations. Specifically the administration has focused on;

a) The use of information and communication technology (ICT)
b) Organizing enforcement functions principally around segments of taxpayers
c) Risk based audit strategies and techniques
d) The use of industry benchmarks and development of segment audit technique guides (ATG)

The changes in the strategies and restructuring of operation has led resulted in significant growth in tax collections as shown in the graph below[2]




The growth has largely been due to intensive audits and adherence to the annual audit work plan.

This paper presents some of the strategic tools that the tax administration has employed in its operations.

2 *The revenue collection from the Domestic Taxes Department more than doubled between 2008 and 2013*

### 3.1 Information technology systems

The Kenyan tax administration has given ICT top priority in modernizing its operations. ICT has the greatest promise to support the audit and compliance functions. The tax administration ICT strategy identified automation as an enabler to the Revenue Administration Reform and Modernization Programme (RARMP). The strategy is based on the commitment to effective leveraging of enterprise-wide information management and enabling technology for enhanced efficiency and effectiveness of services. KRA targets full automation of the Authority and ensuring that IT systems are fully integrated allowing for a single view of the taxpayer and full utilization of IT to enhance compliance and audit activities. To date the automation strategy has resulted in the a number of achievements particularly with regard to Domestic Tax Operations. An integrated tax management system (I-Tax) has replaced the less modern or manual system. The objectives of the I-Tax is to provide efficient & effective services to taxpayers & public and reduce interaction with staff, facilitate seamless sharing of information across KRA and relevant 3rd parties for data-matching purposes in order to detect non-compliance and to facilitate combined enforcement actions and thus provide a single view of a taxpayer. To date the online registration and filing modules have been completed while the next steps will focus on back office operations including taxpayer risk profiling modules

It is the vision of the revenue administration that in future ICT will provide a common backbone to link stakeholders, service providers, Government agencies, their functions and services, so they can achieve public outcomes no one agency can achieve alone. Customers who want to transact with the tax administration electronically will be able to do so. Emerging forms of technology – particularly web-based resources - will become vital tools allowing customers to work with the Authority to access information and solve problems. Taxpayers receive refunds, make payments, and lodge queries without making an appointment, waiting in line, or driving across town.

In addition the tax administration enforcement strategy envisions the Authority working in close collaboration with other Government registration agencies including the Ministry responsible for immigration and registration, the registrar for companies and the National Registration Bureau among others to ensure inter connectivity of information systems. This measure will ensure that information in these systems is used to achieve compliance of unregistered persons.

### 3.2 Market segmentation and specialization program

The Kenyan tax administration has taken steps to improve their knowledge of taxpayer behavior by maintaining profiles of market segments of its taxpayers.

The rationale for organizing the audit and compliance functions around taxpayer segments is that each group of taxpayers has different characteristics and tax compliance behaviours and, as a result, presents different risks to the tax revenue. In order to manage these risks effectively, the tax administration has developed strategies that are appropriate to the unique characteristics and compliance issues presented by each group of taxpayers. The tax administration believes that grouping the segments within a unified and dedicated management structure increases the prospects of improving overall compliance levels. While application of the 'taxpayer segment' model is still in its early stages of use in Kenya, partial implementation has been done by creating dedicated units within the audit and compliance programs of the Large Taxpayers Office

Where compliance risk is detected in one taxpayer, the characteristics of that taxpayer, for example, their specific profession and financial ratios can be used to frame the parameters for selection of other taxpayers for audit. The risk profiles also aid comparison of tax performance over successive periods, and in establishing patterns and trends that may not be visible through the examination of an individual tax file.

Profiling taxpayers in respective segments has also assisted the tax administration in the determination of appropriate structures and strategies in dealing with tax compliance. The administration has thus established specific sector audit and compliance teams. Individual market segments are assigned to examiners with auditing experience, training, and research responsibilities in the specific sector.

The market segmentation specialization program has allowed the Kenyan tax administration to;

- establish industry benchmarks, which are used to rate taxpayers performance against industry averages and peers. The comparison serves only as an indicator of risk and not as a measure of tax avoided.
- evaluate the effectiveness of its audit activity.
- identify those taxpayers or sectors that have a good compliance record and hence defer them from consideration for audit, while focusing on areas of poor compliance. For instance, it has not

been difficult to establish the sectors more prone to non-filing, nil filing, or repeat offenders.
- improve the relationship between the tax administration and the customers (taxpayers).
- increase the rate of voluntary taxpayer compliance and
- make the audit process more efficient and effective.

### 3.3 Risk profiling as a tool for enhancing audit case selection

The audit program uses a systematic identification and determination of audit cases on merit based on certain defined risk factors. This is done through aggregation and analysis of numerous and disparate items of information and making sense of the possible impacts on tax compliance behavior which in effect provides the required intelligence that should drive the development of focused risk treatment (Audit) strategies. The systematic risk analysis is done for each taxpayer segment.

The audit program has developed a framework to provide a clearly defined risk profiling guide for use in selection of audit cases.

Prior to the development of the risk profiling framework audit case selection criteria was randomly done based on the tax returns received. Lack of clearly defined risk profiling guide created a situation where the auditors often selected audit cases by using the last audit as the only basis of case selection. This meant that most taxpayers were never audited and also created issues of integrity as audit selection were left to the whims of the auditors and their supervisors.

Although the risk profiling framework has worked over the years, the extent to which this approach can be relied upon has faced a lot of challenges mainly due to the fact that it is a manual process as the tax administration is still automating the its audit systems. The main problems that have been encountered in using the framework include;

- Increase in the number of taxpayers over the years due to the administration's aggressive recruitment strategies.
- Erratic taxpayers' compliance behavior
- Technological dynamism within the operating environment

In addition to the above, quite often the execution of the selected cases has not always been guided/focused towards the identified risk indicators, due to lack of prioritization parameters. Furthermore we have not been in a position to fully select all taxpayers meeting a certain well defined criteria.

Despite the challenges, the framework has provided guidance on the enhancement of the audit case selection process through the use of a scoring and weighting mechanism to allocate points on various indictors to enable the identification to the most risk prone taxpayers. Based on the results, the taxpayers scoring the highest points are prioritized for immediate action.

The risk management system has been based on the assumption that the audit staff;-

- Fully understand our taxpayers risk behavior
- Have adequate knowledge of all our business processes, linkages and the expected results
- Are aware and understand the defined risk parameters and variables

- Are in a position to select cases whose trend vary from the norm
- Are experienced and fully understand what is expected in addressing the gaps (prioritized risks).

The framework was initially developed in 2008 and has been improved over the years. Its is expected that the implementation of this framework will provide the basis on which a computer aided case selection system will be build on in future.

The Risk Based Cases Selection Framework classifies risks into two levels;-

- Group/portfolio risk
- Individual taxpayer risk

Under group portfolio risk, taxpayers are classified into various categories based on certain risk factors that are common to the grouping and are considered important in tax compliance management. For instance the risk factors may be based on the following criteria;

**a. Business Ownership**

This is based on the premise that motivation to evade tax is likely to be influenced by the mode of business ownership and management. In sole proprietorships and partnerships the owners of the business have higher participation in managing the business and will be the primary beneficiaries of any benefits from tax evasion. They should therefore carry higher risk ratings. Private companies are also likely to have a high owner participation in management. They are however required to undergo audits and file returns with the registrar of companies.

Public (listed) companies have advanced governance structures which are enforced by the Capital Market Authority. They are required to comply with a code of corporate governance. The involvement of owners in management is limited and hence the motivation to evade taxes is reduced.

The other categories identified these category and which and which have relatively low compliance levels include sole proprietorship and partnerships, cooperative societies and trusts and private limited companies

**b. Existence of regulatory framework**

Some sectors have separate regulatory frameworks under separate legislations. This underlies their importance due to the significance of the public interest. Such sectors include banks, insurance companies, corporate societies, retirement benefit funds.

As a result of this additional regulation it may be appropriate to assume that such sectors will be less risky than those without additional regulations. This regulation framework covers financial aspects and corporate governance. It is however important to note that only banks and insurance companies will be considered to have stringent regulation for the purposes of this rating. Other bodies are considered risky under this category because they are regulated only under ethical issues. i.e. Lawyers, doctors and accountants, while the regulation of the rest is not considered to be stringent enough.

**c. Auditors / Tax Agents**

While auditors are regulated, their operations differ in certain respects. Their independence from clients may be contested given that they benefit from the arrangement and their removal from office is largely dependent on the owners of the businesses. Different auditors may have different internal quality control standards which make the quality of their work different.

It is therefore possible to identify similarity in tax behaviour by businesses with the same auditors/tax agents. It is therefore important to trace the cases of tax malpractices to the auditors and on this basis attach risk rating to the auditors based on the frequency & magnitude of tax related malpractices as observed from past experience.

### d. The Sector Risk

Various Sectors are profiled according to certain risk factors and rated appropriately

The Sector classification is based on the nature of business since similar business are faced with similar challenges and have similar transactions. It is therefore possible that they will exhibit similar tax behaviors.

The complexity of transactions in certain sectors makes them prone to tax evasion or under declaration. Risk ratings may therefore be assigned based on perception of sector complexity from past experience.
Sector tax performance is also an important risk assessment indicator. A sector which has consistently performed below the sector revenue target may be presumed to have a higher risk rating.

Individual Tax Payer risk profile is carried out on the basis of specific criteria which may include the following;

- Past Tax Performance Record
- Financial Performance
- Complexity of Company/Taxpayer Operations & Structure
- Frequency of change in Tax Agent /Auditor

Risk profiling taxpayers using the parameters above, the audit officers are required to prepare a risk report for each taxpayer specifies the following:

- Taxpayer's name and identification number;
- The tax segment and the risk ranking of the taxpayer;
- Tax heads and periods to be audited;
- Names of persons preparing, reviewing and approving the report;
- Comparative financial analysis, highlighting patterns, trends, and Variations;
- The perceived risk (reason for audit)[3]

## 3.4 Industry benchmarking and Audit Technique Guide

Benchmarking is a process of comparing a taxpayer's performance to that of other taxpayers in the same industry or sector using objective criteria. This process involves comparison of certain aspects of a taxpayer's business performance with an industry standard. Industry

3 *Details specific areas of focus during audits*

standards are generally based on the average for production ratios as well as basic accounting ratios, calculated using a full years data from financial statements filed by taxpayers. The standards derived are used by tax auditors to benchmark individual taxpayers. The intent of such a comparison is to detect how wide the margin of divergence from the identified standards.

Industry benchmarks are used to refine the case selection criteria.

The Kenyan tax administration has developed industry specific benchmarks for the following sectors;

- Excise Manufacturers- Spirits
- Food manufacturers-maize and wheat flour millers
- Plastic manufacturers.

The use of industry benchmarks plays a significant role in assisting audit officials identify potential evasion cases specifically, the auditors apply the industry bench marks to achieve the following objectives:

- To enhance its risk based audit case selection criteria by identifying averages for groups of activities, and therefore businesses that vary significantly from those averages.

- To determine reasons for variations within an industry and identify action that should be taken to correct the problems and improve business practices, in particular those related to record-keeping, accounting and disclosures.
- To ensure that all the taxpayers within a sector pay their fair share of taxes for fairness and equity and promote compliance with the local tax laws, trade and boarder legislation.

KRA has not developed industry specific examination technique guides (ATG) except for the real estate sector audit guide which is still at the development stage. It is expected that this guide once developed will guide the audits within the real estate segment which is under MST. It is expected that going forward, KRA will develop similar framework for all the market segments to guide the audit staff in the examination of income, interview techniques and evaluation of evidence.

The challenges that the administration has experienced in developing the benchmarks is data availability, lack of homogeneity within the market segments as well as the difficulty of getting statistically relevant sample size. It is however expected that most of these challenges will be overcome once the KRA achieves full automation and effective data mining tools become available to give it a strong indication of

the make-up and behavioral characteristics of its taxpayer population and thus provides the ability to make informed operational and risk management decisions to achieve taxpayer compliance.

The other major challenge focuses on the way the results of the benchmarking process are utilized. This stage is often more important than the benchmarking process itself. Because, if what you learn from the results of the benchmarking process isn't applied to the business, the entire exercise was one in futility.

First is the challenge in achieving the right actions from the results of the process and effectively executing these actions. To accomplish this effectively there needs to be buy-in from all levels of the organization as well as the right culture in place to accept the change due to the new actions. This remains a major concern for the administration. The key to the success of any benchmarking process is in setting up a culture and process of continuous improvement. The tax administration has set up a culture change Program (CPP) across the entire organization to deal with this issue which affects the operations of every organization. As a key learning point, organizations that think about the benchmarking process as a one-time exercise are likely to fail.

The real value of a benchmarking exercise is delivered when you learn from the results of the program, apply those recommendations, track the success of the actions and continuously improve based on the results of those actions.

Yet the other more contentious issue is: What happens next? At the end of it, benchmark only provide risk indicators and are expected to guide the audit team on areas of focus.

Unfortunately the use of benchmarks as an audit tool in Kenya is still quite low. Possibilities that a new directive will offer change are much higher.

## 4. BENEFITS OF MARKET SEGMENT SPECIALIZATION AUDIT PROGRAMS

There are various advantages accruing from structuring audits on sector or market segment basis and these include;

a) There is staff specialization and focused trainings. This leads to high calibre of staff dealing with sector specific issues.

b) The process facilitates benchmarking on industry or market segment basis that provides a good foundation for future audits.

c) The audits are selected after risk profiling and they are issue based. The market segmentation guides this process.

d) The process leads to better understanding of specific market segments issues resulting in higher case coverage.

e) Disputes arising from tax audits are minimised due to audit findings being more objective due to better grasp of non compliance issues. This leads to fast conclusion of cases profiled for audit.

f) The level of voluntary compliance is enhanced once the taxpayers realize that the tax officials more than ever before understand their unique industry issues.

g) Market segment specialization audit programs result in higher yields on audits and this ultimately leads to enhanced revenue collection by the authority. This is a very positive benefit because the core mandate of a revenue authority is increased revenue collection.

## 5 CHALLENGES FACING MARKET SEGMENT SPECIALIZATION AUDIT PROGRAMS

The following are the key challenges faced by the KRA in its specialized sector audit programs;

a) Inadequate staff capacity especially in audit of emerging and specialized sectors such as mining, petroleum exploration and gas.

b) Developing market segment benchmarks takes time due to in adequate macro- economic data which then impacts negatively on achievement of the anticipated benefits in the short run.

c) Resistance to change by staff because the process prescribes new ways of conducting audit activities i.e. risk and issue based as opposed to comprehensive audits.

d) Risk of concentrating on audit of cases from sectors where there is better staff capacity at the expense of new and emerging sectors where there is inadequate staff capacity and lack of benchmarks. This may lead to low compliance levels in the 'neglected' sectors impacting negatively on the overall revenue collection.

e) Constraints on financial resources required to fund technology and automation which is a critical success factor in this process.

## 6 RECOMMENDATIONS

For purposes of making market segment specialized audit programs effective in KRA, the following recommendations are proposed;

a) Building staff capacity in the new and emerging sectors for better audit results. This will improve audit yields and subsequently voluntary compliance.

b) Adequate funding for purposes of acquiring new technology and automation in order to make the process effective.

c) Introducing change management programmes for staff in order for them to embrace new ways of conducting audit activities.

d) Benchmarking against international best practice on this area and specifically adopt what the best revenue authorities in this area have done.

## 7. CONCLUSION

KRA's vision is;

"To be the leading Revenue Authority in the world respected for Professionalism Integrity and Fairness."

In line with the professionalism aspect of the vision, KRA has continually endeavored to be innovative in order to meet its core mandate of enhanced revenue collection. This involves re-engineering business processes and investing in new technology. Pressure to meet very ambitious revenue targets that are compounded every year makes the case even stronger.

Market segment specialization audit programs is part of re-engineering of the audit process with a view to increasing the level of compliance and subsequently enhance the revenue collection. It is therefore critical for KRA to deal with the challenges being encountered in this area and make the process effective since this will go a long way in ensuring that KRA's core mandate is achieved.

This process is part of the on-going initiatives that include Revenue Administrative Reforms and Modernization Programmes (RARMP) whose primary objective is to enhance revenue collection.

*Lecture*

*Topic 3*

# TAX AUDITS: MARKET SEGMENT SPECIALIZATION PROGRAMS

**Karina Venier**
Deputy General Directorate
AFIP
(Argentina)

***Contents:*** *I. Introduction.- II. The new control and audit approach.- III. The new control and audit approach.- IV. The ICTS and their adaptation to the tax administrations changes.- V. Structural segmentation of control and audit functions.- VI. Market segmentation applied by specialized economic sectors.- VII. Segmentation in the chain of generation of the taxable event and tax liability.- VIII. New control strategy. 2013 special control program.- IX. The role of research areas within the new paradigm.- x. Jurisdictional risk matrix. The use of information for control.- XI. Conclusions and challenges.*

## I. INTRODUCTION

The Federal Administration of Public Revenues of the Republic of Argentina has adapted the operational, administrative and structural organization, to generate appropriate operating conditions that will allow the development of tax audits, under the Strategic Plan for the 2011-2015 periods.

The objective is to strengthen the tax administration to fight evasion and broaden the taxpayers' base and controlled operation from an active and expeditious process. In this sense, the implementation of information and communication technologies - called ICT-which gradually facilitates voluntary compliance and the collection of taxes and allow further controls and proper collection planning.

The four strategic objectives: 1) facilitate compliance; (2) control the fiscal behavior; 3) efficiently manage resources and 4) contribute to national development, based on the vision and mission of the Agency, prioritize areas in which the institution is bound to achieve quality in the services offered to the community and to the State, boosting its collection control, audit and service capabilities, thus marking the first segmentation based on strategic guidelines.


**Source:** AFIP, Strategic Plan 2011-2015, page 6.

The following are the four strategic objectives; the first of them should be highlighted, which will address the new segmentation approach proposed by the Agency for control actions.


**Source:** AFIP, Strategic Plan 2011-2015, pag. 8.

## II. THE NEW CONTROL AND AUDIT APPROACH

The Federal Administration of Public Revenues vision is the application, perception, control and audit of national taxes, social security resources and activities related with foreign trade; promoting voluntary compliance, economic development and social inclusion in the Republic of Argentina.

In this sense, the activities oriented to prevent informal operations, concealment of the tax capacity and fraud are a priority. For such purpose, tax administrations, based on Justice and equity principles, have to *adapt* their strategy to design and apply dissuasive and corrective measures that increase the detection risk and effective punishment of illegal actions, for voluntary compliance to always be the most attractive option.

**Control and audit function**, includes verification of compliance of all taxpayers obligations, both the substantial payment of taxes as the formal or administrative; especially those that generate compliance gaps. In this sense, it includes a set of tasks that are designed to encourage taxpayers to comply with their tax obligations, laying the correct, full and timely payment of taxes.

The permanent improvement process tends to deepen structural and systematic measures that will lead to the increase of tax compliance, both in the externalization of the ability to pay and in the correct filing and payment of tax liabilities.

In summary, the objective for controlling the fiscal behavior means to carry out the following associated strategies:

1 Strengthen the main control management.
2 Enhance the control and on-site verification.
3 Systematically induce compliance.

## III. RISK MANAGEMENT [1]

Over the last decade, the trend of tax administrations has been the tax control planning through risk management. This technique spreads from the need to efficiently use State resources for tax collection in an increasingly globalized and complex business world.

1 *RUIBAL PEREYRA Luz, "Experiencia Internacional sobre medidas de reorganización de la Administraciones Tributarias en lucha contra el Fraude Fiscal", Crónica Tributaria 134-2010, págs. 147 y ss.*

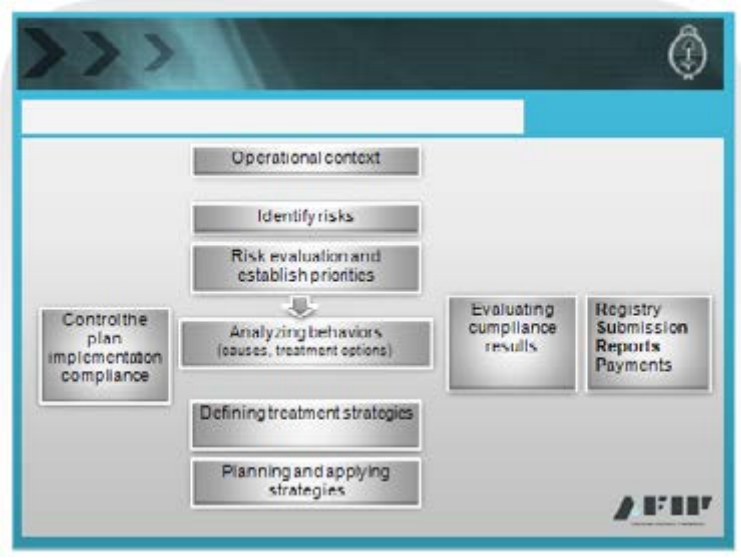
Compliance risk management is based on the premise that tax administrations should seek the maximum level of tax effectiveness, and therefore they have limited resources.

This generates the need to establish priorities when deciding an administrative action, dealing with three variables:

- Determine compliance risks that have to be treated.
- Fix the universe of taxpayers linked or associated with certain risks.
- Define the strategies to be adopted to fight non-compliance

The international doctrine defines the risk management as "a structured process for the identification, evaluation, classification and treatment of the tax legislation compliance risks (i.e. various forms of taxpayers behaviors that cause a lack in the registration, not timely submission of returns, information on tax obligations and tax payment)."[2]

Tax authorities of some OECD Member countries designed the following risk management process model:




The stages of the process can be summarized as follows:

- **Phase 1. Delimitation of the operating context:** both external

2 *OCDE, Segunda Reunión del Foro sobre Administración Tributaria, "Nota de referencia sobre los temas de debate de la reunión", Dublín, junio 2005.*

factors (features of taxpayers and economic activities, legal framework, economic globalization, information exchange; cooperation with other public institutions) as internal factors (training and specialized level, financial resources, infrastructure and technology, standards and control procedures and management) that can influence in the decision-making on the compliance risks management are analyzed[3].

- **Phase 2. Risks identification:** an identification of compliance risks faced by the tax administration is performed by defining as many identifiers as possible (by type of tax, by segment of taxpayers, by risk and behavior), in order to reduce the possibility for evasion and facilitate a detailed analysis.

- **Phase 3. Risk assessment and priority setting:** the main risks are separated from the minor ones. This leads to the need for an investigation of facts and evaluation of the consequences. The result should be a report in which risks are summarized by classifying them according to their priority. To do this matrix models are made, such as the one proposed by the OECD [4].

- **Phase 4. Analysis of the behavior in terms of compliance:** this phase deals with the different treatment options established by tax administrations against tax compliance risks.

- **Phase 5. Definition, planning and implementation of strategies:** It seeks the best strategy based on the taxpayer compliance. Once the strategy is defined it should be effectively implemented which means that an implementation plan that includes the undertaken actions, the responsible persons, etc. should be elaborated.

- **Phase 6. Evaluate the compliance results:** given that the risk management process is dynamic, it is necessary to assess the results or effectiveness of future decisions that may reinforce the implementation of a strategy if the results have been positive, as its change due to external circumstances or for providing the expected results.

3 *LÓPEZ LÓPEZ, R., "Las estrategias de fiscalización", La función de fiscalización de la Administración tributaria.*

4 *OCDE «Compliance Risk Management: Managing and Improving Tax Compliance », 2004, p. 28.*

The OECD recommendation is to segment taxpayers into groups with similar characteristics (large companies, small and medium-sized enterprises - SMEs-, nonprofit, etc.) and the sub-segmentation of the larger groups based on their economic activity. From these variables the risks that will then define the strategies are prioritized.

In the Federal Administration of Public Revenues, from 2005, it was considered appropriate to establish procedures that allow objectively evaluating the compliance level regarding the formal and material duties carried out by taxpayers and/or the responsible ones - from sectors and/or statistically homogeneous groups -, through the assessment of the information available in the agency´s databases. Thus was created the "risk profile system (SIPER)".

According to taxpayers' fiscal behavior, the system assigns them a category, which is regularly updated. There are five categories: A, B, C, D and E. They indicate in increasing order the risk of being controlled. In the ends "Category A" means low risk of being controlled, while "Category E" is high risk of being controlled. Finally, there is a different category called "NI" for taxpayers who have less than six months from the last date the system was updated.

Taxpayers are classified into small, medium and large, according to certain indicators such as sales and number of employees. They are also grouped according to their economic sector, in which they obtain a position relative to others of their same size and economic sector.

The important issue is that taxpayers can easily consult the assigned category, with their password through the agency´s website, and may expose their disagreement regarding the fiscal behavior which resulted in such qualification. In principle, it is through the AFIP website where a claim and a request for reprocessing can be made, and in case the dissatisfaction persists, the claim may be done in person at the unit where they are registered and provide the supporting elements deemed necessary to reevaluate their situation.

Another issue to be highlighted is that all areas should take the necessary precautions for the update to be done on time, since the correct categorization of the taxpayer and the consequent image of the agency depends on this updating.

## IV. THE ICTS AND THEIR ADAPTATION TO THE TAX ADMINISTRATIONS CHANGES [5]

As a result of technological progress, tax administrations have been restructuring their communication with taxpayers. The internet's impact on the entire tax administration structure through the use of information and communication technology (ICT) is very important. At the same time, the results of the use of internet are projected on different aspects of the tax administration, allowing a higher data capture and a more efficient treatment, so it is possible to start a control process right from the time the taxable event is performed and from the time of returns submission.

It is essential for tax administrations to have fluid information with the taxpayer. This has positive consequences for both parties since it allows the tax administration to perform an accurate risk analysis, either by sector or by practices that carry a risk for fraud and to establish consultation forums with associations or groups. The use of new technologies speeds and optimizes the technical work and increases the efficiency and effectiveness for achieving results, [6] and feeds the decision-making areas.

Telematics media can help to establish a first level or a massive control filter for those taxpayers on which the tax administration has tax data available. So, ICT applies the tax system to most taxpayers. It will be in further controls where ICT must allow individual or sectorial study which requires a human component for the research and decision making.

Databases or data sources such as the following are very important for identifying risks: the data in their own tax self-assessment, third-party information, public information or information as a result of tax controls. In any case, the information must be in an integrated organization that exchanges data in order to apply all their effects.

## V. STRUCTURAL SEGMENTATION OF CONTROL AND AUDIT FUNCTIONS

The Argentine tax administration continually modernizes its approach and consequently its structure and functions. Historically, a structural

5 *RUIBAL PEREIRA, Luz, "Experiencia Internacional sobre Medidas de Reorganización de las Administraciones Tributarias en la Lucha contra el Fraude Fiscal.", IEF. Crónica Tributaria N°134-2010, pág. 143-178.*

6 *GUTIÉRREZ GONZÁLEZ, N.: «Instrumentos de apoyo para el acompañamiento de las fiscalizaciones», La función de fiscalización de la Administración Tributaria, p. 215.*

organization with a unique approach (only for taxes, for functions, only by type of taxpayers, or by territory), modified its approach to a mixed organization, dividing it by functions, specializing by type of taxpayers; considering both their size and their economic sector.

From December 2012 is underway a so-called electronic control mechanism, allowing massive controls, based on an intelligent matrix that will alert the inconsistencies[7]. This innovation is the achievement of true Data Mining information that works based on the agency's data on real estate, registered movable assets (vehicles), credit card transactions, among others.

At the same time, due to the size of the country, the territorial aspects have led to keep the segmentation which is traditionally set for the operational phase. The territorial jurisdiction is segmented in 25 regional directorates, monitored by higher level units.

With the same sense, the taxpayers' segmentation by size has been instrumental for preserving the collection. This requires a permanent follow-up to those larger taxpayers and the implementation of more complex tax audits, multidisciplinary and highly qualified audit teams.

## VI. MARKET SEGMENTATION APPLIED BY SPECIALIZED ECONOMIC SECTORS

### 1. Sectorial specialization

The value chain analysis of each economic activities creating traceability for its control is critical for defining control strategies.

An area of the agency--created a decade ago - is responsible for the analysis of specialized control reflected in sectorial researches and studies. This way, it provides to the monitoring areas many useful tools for the proceedings; in addition it transmits knowledge to the rest of the Organization through different dissemination actions.

The analysis consists of micro aspects and macroeconomic studied activities, description of production processes and forms of operation, tax liabilities, presumptions of evasion control strategies for such activities and mechanisms that allow mitigating that evasion, among others.

Sectorial specialization requires management capacity, the intensive

7 *AFIP, Gacetilla de Prensa N° 3489, "La AFIP detectó 285.152 irregularidades de contribuyentes en cruces informáticos", 21 de marzo de 2013.*

application of technology, the efficient use of information and training, and the specialization of human resources to determine patterns of behavior and risk profiles that combine the characteristics of the economic sector with different taxpayers.

For the success of this work there are pilot audits which allow feedback techniques and modes of evasion in each sector. From those activities which record the chain of operations from a small number of companies, the subsequent step is the proposal to impose systematic information systems that facilitate the control through powerful computing crosses.

The exploitation of information is essential to reliably know:

- The tax treatment of the economic sector.
- Size and composition of the sector in terms of the number of economic agents included.
- Gross domestic product of the sector and its participation in the national GDP.
- Identify the main activities and their characteristics, placing them within the production and marketing chain.
- Know the gross value of production of the main products generated by the activity.
- Location of the production and marketing centers, noting the geographic concentration.
- Identify the existence of units in the sector (production and sales).
- Location of production and marketing centers. Observe the geographical concentration.
- Identify the existence of units in the sector (production, marketing, etc.).

Once the data related to the economic sector is known, it is necessary to identify the most important agents, in terms of tax interest, to whom the control actions will be addressed.

After having identified the sector´s main activities, the production stages and the main agents involved, the next step is the design of mechanisms that allow taking advantage of the special characteristics of these agents to enhance control and supervision work of the sector.

Several countries have implemented tax withholding and levying schemes, leaving this responsibility to taxpayers who belong to concentration stages within the production and marketing cycle of products.

The implementation of a control system based on the detection of evasion sectorial gaps is not easy, as their achievement may impact institutional exogenous factors and the institution itself.

During the development of the actions it is important to document the assumptions of evasion and control strategies used, putting together a manual for the analyzed sector containing various ratios or specific indicators that should be verified in each activity and that, unlike traditional indicators, can allow to quickly detect the existing levels of evasion.

This analysis provides important guidance for future actions allowing standardizing the work of teams that are responsible for the implementation of control programs.

As a second product, as valuable as the sectorial manuals, "Technical reports", are prepared, where complex tax treatments that adequately explain application criteria of the tax law when it is difficult to define its interpretation. Similarly, these materials provide support for tax audits.

Finally, the studies on "Control Methodologies", it is not focused on the economic activity but on the marketing and finance chain trying to define the inks to elusive or evasive maneuvers. For these neuralgic points an appropriate audit methodology is designed.

**2. Specialized control analysis**

Other current actions relate to:

- Analyze, assess the risks and establish profiles.
- Promote actions aimed at preventing tax crimes. Coordinate the development of research activities aimed at the control of taxpayers in various economic activities.
- Development of techniques for the control of taxpayers. Understanding the design of research and control processes as including monitoring and evaluation.
- Understand the definition and follow-up of activities enabling to validate research and control hypothesis.
- With the competent Department, coordinate training activities aimed at the improvement of the staff responsible for the control activities of the agency.

## VII. SEGMENTATION IN THE CHAIN OF GENERATION OF THE TAXABLE EVENT AND TAX LIABILITY

As it was explained in section VI, while the traditional view which is not left side, a new control strategy is added.

The dynamics imposed on the business organization induce the tax administrations to introduce changes in the management, in order to have an efficient performance more in line with the moment in which transactions with tax effects are produced. The premise would be less "ex post" and more concomitant control.

This change of paradigm has a decisive impact in the management process. It also requires new occupational specialization, deep changes in the work procedures and substantial changes in the design of organizational structures.

In other words, this new form of segmentation of the control procedure is focused on the generation stage of taxable and tax event, advancing the control to the "ex ante" phase.

Therefore the anticipation in the generation of perceived risk to the taxpayer leads to renouncing to a fraudulent conduct due to the high probability of being detected.

During the current year the specialization programs of this new form of segmentation are being developed, which is described below:

## VIII. NEW CONTROL STRATEGY. 2013 SPECIAL CONTROL PROGRAM

With the purpose of improving the control of the taxpayers' behavior, and for the purpose of increasing the compliance level, both the exteriorization of the contributing capacity and the correct return and payment, AFIP creates a special control program (PEF) which establishes the implementation of controls prior to or close to the expiration of tax obligations. It seeks to cover a greater number of taxpayers to be audited, immediately and efficiently using the information that the agency has, to avoid informal operations and concealment of contributive capacity.

Through the creation of this new paradigm of control, the Federal Administration incorporates the pattern control 33% of the total census of active taxpayers each year, in order to control the totality of registered taxpayers in 3 periods (2013-2015).

In this sense the procedures defined allow to infer beforehand the minimum magnitude of the respective fiscal obligations, contributing to the strengthening of the primary control management, enhancing control and induction for voluntary compliance.


In the elaboration of the program the macroeconomic indicators considered in the national budget for the year 2013, the experience gained in the planning of previous years and the availability of human resources in different areas of the control process, as well as the implementation of intelligent control scheme allows increasing the number of audits immediately and efficiently.

The Special control program establishes the scope and general guidelines that the control areas should follow. In accordance with the guidelines for implementing the program, a new classification of the audits is set in a joint vision of the three pillars of AFIP, i.e. tax customs and social security, as it is reflected in the following scheme:


## 1. Ex – ante controls

Those control actions that allow the evaluation of taxpayers prior to the taxable action or to the exteriorization of their fiscal situation. In the customs field, those are actions that are carried out prior to the presentation of the import shipment and in the case of export the bill of lading. These audits are divided into:

**Advance affidavits:** Includes actions performed on submissions that are carried out by taxpayers that must report their operations through different created or to be created anticipated information regimes, such as: tourism and travel abroad expenses, football players (DJAF) and payments abroad (DAPE).

**Operational:** Includes massive control actions carried out by supervisory personnel, in shopping areas, routes, access, in order to detect tax breaches in real time. These actions are deepened at strategic points of public affluence, higher turnover and consumption in retail sales to final consumers, control of routes and access of goods.

## 2. Simultaneous audits

They are those control actions that are now "very close" to the completion of the taxable transactions. They are intended to increase taxpayers risk perception through systemic tools aimed at correcting deviations, avoid informal operations and concealment of contributive capacity.

They are based on systemic crosses predefined by the AFIP central areas, and will use in an efficient and immediate manner, among others, data provided by agents of information, electronic invoicing and risk matrices.

The results of the above mentioned crosses will be segmented according to the criteria of generating areas, and any simultaneous actions listed below shall apply:

**a. Online simultaneous audits:**

- Informational schemes: Actions generated from the detection of deviations resulting from crosses made with data provided through information regimes, that warrant the generation of control information orders


**b. Electronic simultaneous audits:**

They include those actions that are intended to "encourage" the taxpayer to declare properly or correctly. They involve the generation of "electronic tax requirements" that must be answered online by taxpayers subjected to this form of control, through the service available on the institutional web site of the Agency.

Automated analysis allows the systemic resolution of those audits in which the response provided by the taxpayers to the "electronic tax requirements" are satisfactory, and the remaining must be reviewed

through the intervention of the areas that are in charge of the "E-audit" actions and if necessary, through a "on-site control".

The simultaneous electronic audits provide the following modalities:

- **Systemic control:** A notification of the commencement of the procedure of "electronic control" is sent to the fiscal domicile of the subjects that are selected to be controlled by this mode. The aforementioned subjects shall, within the period of ten (10) days counted from the day following the notification, respond online to the "Electronic tax requirement". This period shall be extended only once and for the same term at the request of the person concerned. When the required subject, send the "electronic fiscal requirement" answer, he can attach additional information deemed relevant.

- **e - control:** Taxpayers who are selected, are submitted to the areas that are in charge of the "e-control" task so that they proceed with the analysis of the digital file consisting of "fiscal electronic request" answered or not answered and the additional data that they might have provided. "E-audit" agents have no contact with the taxpayer, they are limited to solve cases with the information received and the one they can obtain from queries to the organization databases. As a result of the analysis, the case will be filed or classified for being sent to the investigation area.

- **Personal control:** Personal control is limited to the verification of inconsistencies which originated the selection of case and other aspects that, collected by research area, reinforce the predefined risk hypothesis. The controllers involved should collect the documentary evidence and calculate the adjustments based on the detected inconsistencies.

The scheme below shows the most relevant on-line control actions:


### 3. EX- POST audits

They include those intensive inspection actions performed after the affidavit are submitted. Below are the classification levels:

- **Comprehensive audits:** Audits aiming to confirm multiple and/ or complex evasion hypothesis.

- **Specific audits:** Audits covering specific products or topics and which must be processed in short times. They are aimed at the analysis of specific inconsistencies that allow adjustments. This type of control is applicable to taxpayers who are selected from centralized pre-made crossings or either defined by the research areas from the “Jurisdictional risk matrix', as well as for those cases generated in research areas that meets the requirements for processing under this audit modality. The audits may be field audits or not. The desk audits are known as "Verifications”.

## IX. THE ROLE OF RESEARCH AREAS WITHIN THE NEW PARADIGM

Research areas are an important link in the control process, their main function being the analysis of cases with significant fiscal interest, resulting in adjustments that can be collected and penalties that can be applied.

One of the fundamental variables that they directly or indirectly explain,

the contributory capacity of taxpayers is the level of economic activity; It is for this reason that the tax administration orders and gathers data managers according to categories similar or homogenous, taking into consideration the way in which distributed production units are combined.

Given this situation, and bearing in mind that there are different economic activities, each of them with different performance characteristics, it is important for operational areas to be aware of the economic grouping of the taxpayers they must manage.

Also, investigation areas have a big role in the new control process, since they may receive cases from ex-ante inspections, through the affidavits in advance and from "online" simultaneous audits, from computer crossings of different information regimes. Besides these areas, they also receive as a result of the analysis, cases that are for "classification for investigation" from e-audits, made in the process of simultaneous electronic audits.

## X. JURISDICTIONAL RISK MATRIX. THE USE OF INFORMATION FOR CONTROL

An important novelty for the 2013 control program is the implementation of the **"Jurisdictional risk matrix" (JRM)** tool, which allows to produce crosses by operating areas from information of taxpayers under their jurisdiction. A universe of taxpayer and/or responsible may be selected with an alleged tax interest, by setting filters and/or parameters in order to get cases to audit with particular inconsistencies, which can be linked to different aspects such as a particular activity, joints of regional economies or characteristics of the jurisdiction.

The centralized exploitation of information both internal as from other agencies of the State and from private sector organizations forced to provide information is strongly developed.

So, the operational areas can create systemic crosses by using the **MRJ***,* regardless of their obligation to continue generating audits from their areas of competence, using traditional methodologies.


**NOMENCLATURE OF ECONOMIC ACTIVITIES FIRST LEVEL**


Simultaneous control actions are fed by created information regimes. Such schemes provide data concerning : private schools; fairs; rural properties; producers of insurance; registered assets (aircraft,

automotive, boats, etc.); real estate[8]; information from clerks; expense; trusts; Bank accounts; Government securities; credit cards expenses; ownership and transfer of shares; e-commerce; e-invoice scheme; Lottery agencies; transport flows, operations of grains; application for foreign currency; donations; employment information; consumption of public services; among others.

The following is a graphic showing some of the control strategies carried out based on the information gathered by the Agency, considering only some items:

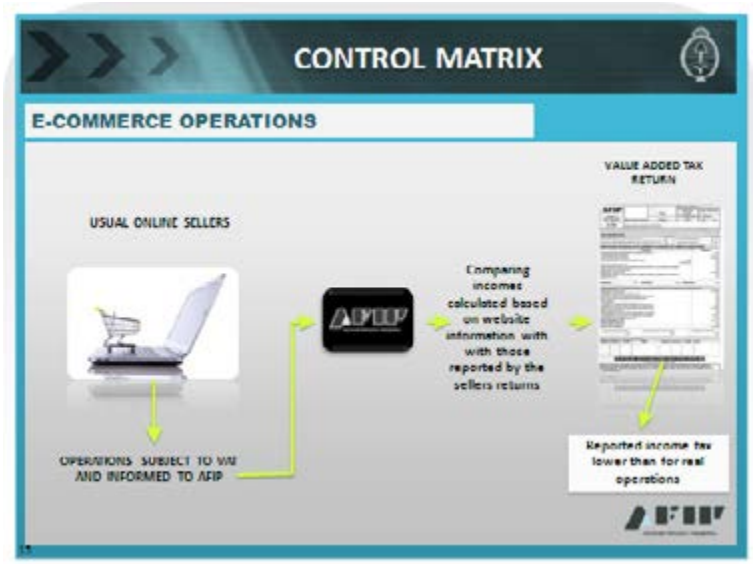
a) Registered assets


b) Income and consumption

c) Credit card commercial transactions

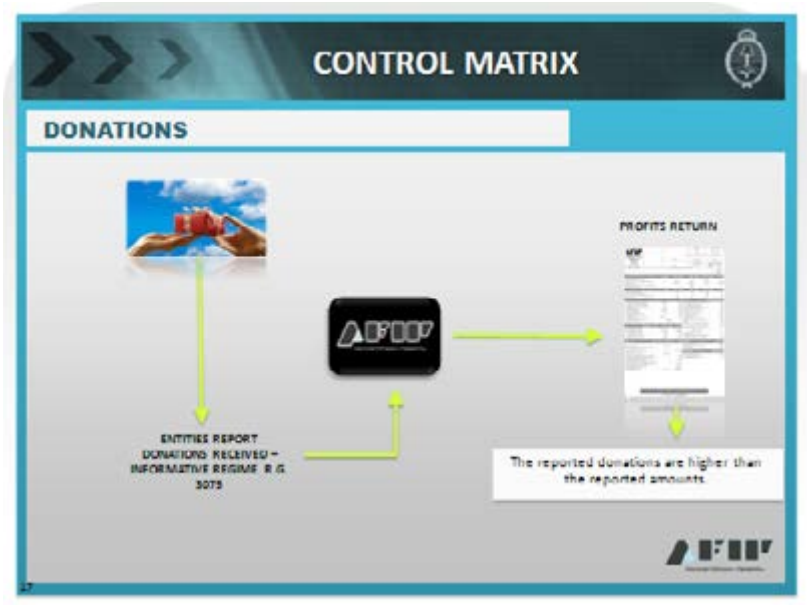

d) Luxury cars purchased by taxpayers registered in the simplified regime of small taxpayers (single taxpayers).

e) e-commerce operations




f) Control of soybeans existence.

g) Donations




## XI. CONCLUSIONS AND CHALLENGES

The new control strategy rests on three pillars: the optimization of available technology, centralized operation of the information, and the ex-ante and online control operations from the taxable event.

The results obtained in the year 2012, in which the new electronic control system began to be used selectively, marked a green light to the new course. For this the Organization for Economic and Cooperation Development - OECD – recommendations were considered during the 7th Forum on Tax Administrations, which was held in the city of Buenos Aires in 2012.

New transverse control design arises from the combination of various segmentation variables.

Among these initiatives, some of them are shown below as a sign of the path to be taken.

## INITIATIVE
## STRENGTHENING TAXPAYERS' SELECTION SYSTEMS

**What caused this approach*?***

The current systemic tools for the analysis and selection of taxpayers to control require an extension of the analysis and response capacity. The logic of integrated processes to current applications limits the potential for analysis of large complex universes, with multiple variables and different management of the Agency.

**What are the expected results?**

Increase the capacity for analysis of potential universes to audit. Redefine the existing computer applications into a new one, allowing optimizing the detection of inconsistencies and the selection of cases to be investigated by control areas. Intensify the use of technological resources for the centralized and decentralized selection processes of taxpayers based on their tax behavior.

## INITIATIVE
## INFORMATION EXPLORATION AND RESEARCH TOOLS

The Federal administration has large volumes of information that allow relating taxpayers by different criteria. It requires a system that allows viewing relationships, searching paths and exploring the relationships at different levels to facilitate the analysis. In addition, it is necessary to standardize the contents of the reports that are generated on the taxpayer's data through a tool that allows selecting its different components.

**What are the expected results?**

Progressive implementation of data of different relationships between taxpayers of internal and external sources, adding to each taxpayer reports and dynamic reports based on default queries that will be part of a library.

**INITIATIVE**
**Processing of complex events**
**What caused this approach?**

Implement the necessary infrastructure for the detection in real time of significant events for management, for its immediate treatment in terms of "alerts". It is expected to gradually incorporate events from the agency´s multiple systems and treat them according to predefined rules and patterns

**What are the expected results?**

Within the framework of technological innovation addressed by the Agency, the infrastructure components have been develop to address the implementation of a real-time alert monitoring and control system on specific situations and patterns.

**INITIATIVE**
**TAX REGISTRATION OF MINING COMPANIES**

**What caused this approach*?***

This Federal Administration implements a Fiscal registration of mining companies, which will reach all mining companies and mining services registered in the mining investment regime under the law N ° 24.196. It will be updated according to the Ministry of mining regulations.

**What are the expected results?**

To know the universe of taxpayers in the sector, the number of projects and their location, the stage of the project for individualizing the benefit obtained or to be obtained in the subsequent stages, type of ore that is extracted which later is exported; constant updating of data. To increase the perceived risk in the sector.

**INITIATIVE**
**TAX CONTROL FOR MARINE FISHERIES**

**What caused this approach?**

The need to increase the tax control actions over the sector´s operators. To improve tax compliance by implementing structural control measures (registration of operators, differential retention regime). The need to regulate the "main" sales of fish documentation.

**What are the expected results?**

To reduce the sector´s evasion levels. Identify all members of the marketing chain. Implement the "main purchase liquidation". To induce a greater degree of tax compliance by the sector´s taxpayers.

This Federal Administration is well aware that in every one of their actions, the vision is to consolidate itself as an institution of excellence aimed to generate a fiscal climate that favors the formal economy, the registered employment and the security in foreign trade.

Therefore, no efforts are spared in carrying out the activities aimed at preventing informal operations, concealment of the tax capacity and tax fraud.

*Lecture*

*Topic 3*

# TAX AUDIT: MARKET SEGMENT SPECIALIZATION PROGRAMS

**Martine Meunier**
Head of the Interregional Tax
Audit Directorate
General Directorate of Public Finances
(France)

***Contents:*** *Summary.- Introduction.- I The needed specialization of tax audit services.- II. Results and Prospects*

*Presentation PPT*

## SUMMARY

The complex and ever-changing tax legislation in a context of globalization of the economy makes the tax audit increasingly difficult, requiring greater specialization of teams.

France implemented long ago specialized structures taking into account the level of income or turnover of companies.

Regarding individuals, the procedures relating to income tax and net wealth tax are particularly regulated requiring dedicated structures when the stakes call for it.

Regarding businesses, the general audit is the standard.

Whilst, in France, segmentation by tax types for field tax audit of companies does not exist anymore (e.g. units dedicated to corporation tax, to VAT ...), specialization currently carried out allows tax audit teams to understand very accurately the reality of an economic sector.

Since 1971, the largest companies have been audited by a national Directorate that implemented units specialized by socioprofessional areas.

Beyond this specialization by economic sector, various support and technical assistance structures have been introduced in order to allow high quality tax audit.

**INTRODUCTION**

Tax audits in France take two fundamental forms: desk audits and field tax audits, both using different methods and following different procedures.

The two main types of audits:

- The desk audits are carried out on the basis of taxpayers' returns and documents that the administration may get from third parties. They aim to address the absence of return, including sending reminders to defaulters, and to correct specific errors and irregularities that affect filed returns.

- Field tax audits, accounting audits for business and personal tax situation investigations for individuals, shall be notified to the taxpayers and follow strictly codified procedures.

When it comes to businesses, auditors usually visit them on-the-spot.

When it comes to individuals, discussions tend to take place in the administration's premises. They may cover all income and assets and all taxes due.

The audits are the responsibility of several categories of services.

**The desk audit** is carried out by the local Directorates of public finances
(DDFiP) for individuals and most businesses. And for the 35,000 largest, it falls under the large taxpayers' office (DGE), of national jurisdiction.

**The field corporate tax audit** is performed depending on their turnover and their geographical location, by the local Directorates of public finances for smaller ones, by ten Directorates of tax audit (DIRCOFI) with an interregional jurisdiction for medium ones and by a Directorate of national and international Tax Audit (DVNI) for the largest.

**The field audit of individuals** is shared, depending on the amount of the income of the taxpayer and the complexity of the case, between the local

Directorates of public finances, the interregional tax audit Directorates and the national Directorate for examinations of tax positions (DNVSF).

**Tax audit issues**

Approximately 52,000 on-the-spot tax audits are performed on a yearly basis, including 48,000 tax audits of companies and 4,000 investigations on the overall personal tax position of individuals. Desk tax audits reach hundreds of thousands files and are twice as many on the personal income tax as on the corporate tax and VAT.

Local Directorates of public finances, interregional tax audit Directorates and the large business taxpayers' Directorate generate all of the desk checks and 96% of the on-the-spot tax audits.

Tax audits related to international operations, especially those related to the ownership of unreported assets and income offshore are mostly operated in Directorates with national responsibilities.

## I. THE NEEDED SPECIALIZATION OF TAX AUDIT SERVICES

### 1. The specialization of the tax audit of individuals

The National Directorate of audits on the tax position of individuals, established in 1983, is in charge of the implementation of the French own specific procedure of examination of personal tax position (ESFP) on the most significant cases both in terms of stakes and notoriety.

The very specificity of this procedure and the complex structures faced led this Directorate to specializing some personal tax audit units in financial and international matters.

Recently (September 2011), this Directorate was entrusted with the correlated overall desk check of the cases at very high stakes that meet the following alternative criteria:

- total gross income for personal income tax> 2 Million €
- gross asset subject to wealth tax (ISF)> 15 Million €.

These desk checks that cover both income and assets are carried out by special purpose entities "the patrimonial units" that mobilize all the expertise required for the examination of the faced issues and allow to implement more extensive investigations.

The local services shall carry out checks on income and correlated checks on minor cases when the situation calls for it.

**2. The specialization of the tax audit of businesses**

· First, specialization according to the significance of the turnover

Tax issues and implemented means of investigation can not be the same according to whether international groups or small and medium enterprises (SMEs) are dealt with.

Directorates such as DVNI and to a certain extent DIRCOFI, particularly in Ile-de-France (Paris and its suburbs), are therefore especially operational on the tax audit of large scale companies, counting on appropriate training and an efficiency gained through experience (e.g. on international taxation - especially transfer Pricing ...)

The DVNI's scope of action includes 1,000 groups and 1,300 independent companies accounting for a significant economic weight (55% of the turnover generated in France).

· Second, for all operations of on-the-spot tax audit, specialized units specific to the examination of electronic accounting records are implemented. These units have been in place for some considerable time in the DVNI and are becoming more common in DIRCOFI.

They consist of specialists able to analyze data processing or to perform them on their own most of the times using the audit tool ACL.

They operate upon the request of tax auditors and carry out their cases until litigation to reply to the companies on this aspect.

· Furthermore in order to take into account economic facts, as regards the on-the-spot audit of medium and large businesses, units specialized by socio-professional field exist in the DVNI and in some DIRCOFI.

DVNI: 10 skills centres

• Steel, Metallurgy, Automotive
• High Tech
• Chemicals, Oil
• IT and consulting
• Construction - Public service concession
• Media, Advertising, Real Estate

• Food industry
• Large retailing
• Banks, Insurance
• Luxury, Pharmaceutics

DIRCOFI-IDF EAST : 10 skills centres

• Industrial Activities
• IT activities
• Real Estate
• Construction
• Transport, Car selling and repairing, Travel Agencies
• Textile / Clothing
• Communication, Press
• Financial and Legal Activities
• Healthcare and miscellaneous services
• Food Industry

## II. RESULTS AND PROSPECTS

### Results

Segmentation is an asset:

- to cope with the complex and ever-changing tax legislation;
- to professionalize teams that can discuss on equal terms with lawyers and business counsellors;
- to be more effective and present a good image of the administration.

**Segmentation may still suffer some drawbacks:**

- lack of critical skills when dealing with new fraud patterns,
- lack of a comprehensive look when dealing with a corporate group and the position of the managing team,
- need to coordinate the work of several specialists and establish connections with separate Directorates.

### Prospects

To cope with these drawbacks, teams fully dedicated to supporting auditors are set up by the Directorates.

**DVNI's pattern:**

A consultants unit consisting of former specialized tax auditors in particular, in international matters of transfer pricing or in financial arrangements.

These specialists operate on-site to support the auditor.

**DIRCOFI's pattern:**

Positions of experts selected by a jury are deployed in DIRCOFIs in various fields:

- international expert
- financial expert
- net wealth expert
- criminal expert
- etc ...

They can be asked for at any time by the auditor to direct a tax audit and analyze the observations made on site.

**CONCLUSION**

In a context of economic globalization and development of the digital economy, tax planning of companies becomes more and more aggressive requiring very close scrutiny and responsiveness to risks of substantial loss of tax-base by the political authorities.

Against this background, inspection services must demonstrate greater adaptability and vigilance regarding business strategy choices.

The specialization by business segments and the availability of recognized experts can be a response to these challenges.

*Case Study*

*Topic 3.1*

# AUDIT OF THE GAS, PETROLEUM AND OIL SECTORS

**María Elena Barberan**
National Head of Large Taxpayers Department
Internal Revenue Service
(Ecuador)



## 1. IMPORTANCE OF THE TOPIC

Since ancient times, man has seen the need to dig and bore the soil in order to access the wealth found in the subsoil, such as water, salt and oil (Gómez, 1999)[1]. Thus, the history of oil and natural gas dates back to the origins of humanity. As an industry, it may be said that it appeared in the United States in the mid-19 century, where the drilling method for extracting salt resulted in the possibility of industrially exploiting the oil wells. Already in 1870, there was a consolidation of companies that controlled all the oil pipelines and refineries within and outside the oil-bearing regions, thus acquiring full control of the world's oil trade. Finally in the nineties, the markets were expanded to Europe, the Middle East and Latin America (Gómez, 1999).

Since then, the main characteristics of this economic activity has been: i) the concentration in large and at the same time, few transnational companies, ii) the grouping of countries counting on such wealth in organizations that allow them to coordinate their respective policies; and iii) the constant volatility of prices. Undoubtedly, these factors combined with the wealth in this type of natural resources in several countries implied a stage of expansion in their economies, but which at the same time, brought with it, serious and even devastating environmental consequences. In this regard, it must be mentioned that Latin America, for example, is of special importance since it concentrates 18% of the proven oil reserves at the world level; which

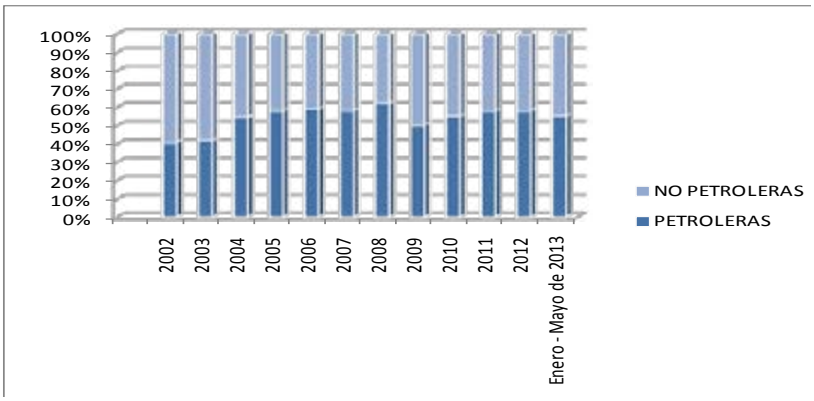
1 *Gómez, José Lino (1999) Manual Técnico Petrolero. Colombia: CENSAT*

figure is only exceeded by 55% of reserves in the Middle East. As for natural gas, proven reserves already amount to 4.8% at the world level (OLADE, 2011).[2]

In Ecuador, exports of primary products (little value added) represent an average of 78.5% concentrated, in four basic products: crude oil, banana, shrimp and fresh flowers, of which oil has the greater participation (45.7% between 1990 and 1999; and 68.6% between 2000 and 2012).

The following chart shows the distribution of oil and non-oil exports from Ecuador, where one may also observe the importance of oil in the Ecuadorian economy:

**EXPORTS FROM ECUADOR**




Source: Banco Central del Ecuador, July 2013

Oil revenues in Ecuador represent approximately 22% of the gross domestic product (GDP). In 2012, exports amounted to184.5 million barrels, of which 73% corresponded to public production and 27% to private production. The price of crude oil from Eastern Ecuador had an average valued of USD 99.49 per barrel.

According to figures of May 2013, 38% of oil-products were imported and 62% corresponded to national production. Imports amounted to approximately USD 417.8 million, while revenues generated represented USD 138.5 million. It is worth mentioning that some by-products are subsidized by the government.

2 *Organización Latinoamericana de Energía [OLADE] (2011) Manual de Estadísticas Energéticas*

### 1.1. Scope and contents

This document includes a brief explanation of the structure of the Ecuadorian oil sector where one may identify the players who participate in the upstream, midstream and downstream processes, as well as a summarized description of the contractual changes that occurred in the private companies that belong to the hydrocarbon exploration and exploitation sector.

It also includes a general approach to the tax assessment or examination process used in Ecuador, as well as the normative, administrative and technological sphere that comprises this process.

Likewise, it shows the results of examinations of companies from the gas, petroleum and oil sectors, with respect to amounts of debt generated as well as the identification of important risks in said sectors, in addition to the future perspectives that could affect the development of current activities.

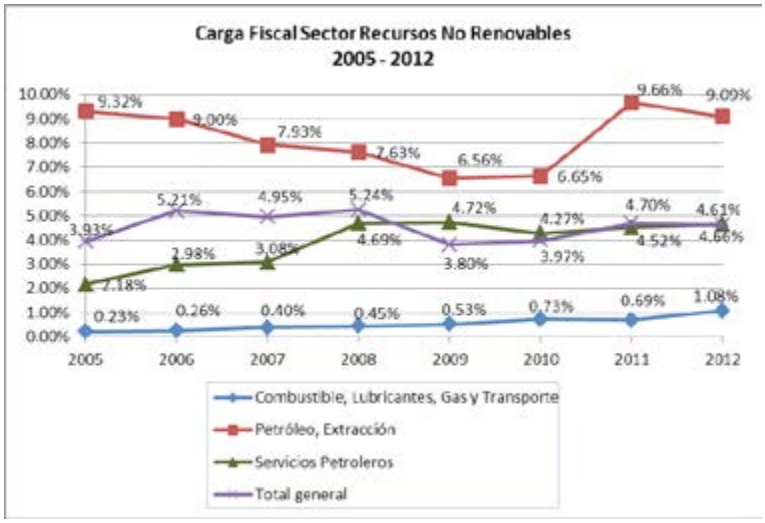
### 1.2. Current situation

The Tax Administration has the National Large Taxpayer Area which is in charge of the cadaster of the 270 most important companies of the Country. Its main role is to follow up and control through the segmentation of the cadaster in economic sectors and with specialized staff in each of the sectors. The main functions of the staff are: follow up the tax behavior of the taxpayers, provide counseling to the large taxpayers and support and supervise the control processes carried out in the Regional Large Taxpayer Areas, where there are also specialized teams.

Within the large taxpayer cadaster there are 29 companies belonging to the petroleum sector, namely:

- 10 petroleum extracting companies
- 1 providing transportation (oil pipeline)
- 6 providing petroleum services
- 12 petroleum by-products (including lubricants)

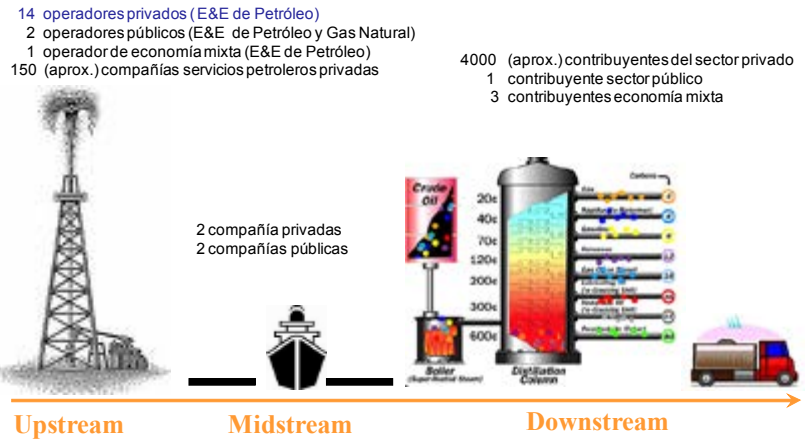
The graph below shows the evolution of the tax burden (Income Tax incurred / total revenues) for these sectors:




The Ecuadorian petroleum sector consists of the following types of companies:

- **Upstream:** Gas and petroleum extracting companies of a public, private and mixed nature and petroleum service companies of a private nature
- **Midstream:** Petroleum and gas transporting companies (public and private)
- **Downstream:** Public and private companies of petroleum by-products: GLP, fuel and lubricants.

Below is a graph showing this composition:



As may be seen, the petroleum sector has many participants which may be public, private or mixed. It is important to point out that the sector comprising the petroleum extracting and exploiting companies in Ecuador have undergone an important and drastic change regarding its way of working with private Enterprise. Hereunder is a brief summary:

- Prior to the contractual change implemented by the Ecuadorian government, private companies extracted crude oil, exported it, received revenues and paid Ecuador a fixed participation in each contract. The current modality is that petroleum belongs to the State and the Private Companies receive a payment for the petroleum exploitation service provided.

- Since late 2010, Public Companies increase their production after absorbing some of the fields that were operated by Private Companies which left the country in November 2010, in view of the changes in contract modalities implemented by the National Government.

## 2. AUDITING PROCESS

### 2.1. Definition

It is defined as the procedure intended to determine the correct main or substantive tax obligation, as well as the accessory or formal ones. This audit uses in practice, the same procedures of financial auditing.

According to the internal tax regulation, the assessment of the tax obligation is the act or series of regulated acts carried out by the active administration, intended to establish, in each particular case, the existence of the generating event, the taxpayer, the tax base and the amount of the tax.

The exercise of this power involves: verifying, complementing or amending the returns of the taxpayers or those responsible for the tax; the composition of the corresponding tax when taxable events are detected, and the adoption of legal measures that may be deemed convenient for such assessment.

The Tax Administration’s assessing power initiates the issuance of the assessment order which is notified to the taxpayer and concludes with the definitive assessment act.

The process is based on the existing tax regulations, as well as on internal procedural guides for their operational execution. There is also a National Tax Auditing System which allows for controlling the flow and storage of information (from the taxpayer, third parties, internal sources, working papers, etc.).

There are four well defined phases: Planning (identification of risks, materiality and programs), Execution (analysis of the risks identified through the application of the programs), Consolidation of the Opinion (preparation of the draft document and meeting with the taxpayer to explain the preliminary results found for his defense) and Communication of results (issuance of final assessment document).

### 2.2. Legal aspects

In general, the petroleum sector abides by the following legal regulations: Constitution, Hydrocarbons Act and its regulations, Tax Code, Internal Tax System Act and its regulations, specific ministerial agreements and decrees, as well as that provided in the contracts signed with the state.

### 2.3. Petroleum by-product sectors

In the fuel commercialization sector there are certain special features with respect to:

- The calculation of the Income Tax advance payment has a different percentage from most of the others, since instead of calculating 0.4% of the total taxable income it calculates it on the total of the commercialization margin.

- Presumptive VAT withholding: it is done inversely to what is normally applied to taxpayers in general; that is, the state company and fuel marketing companies when selling petroleum by-products to the distributors must withhold the Value Added Tax calculated on the marketing margin that corresponds to the distributor.

#### Petroleum sector

With respect to the pertinent regulations, the Hydrocarbon Law as well as the chapter on Taxation of companies providing hydrocarbon exploration and exploitation services of the Internal Tax System Act were amended in July 2010 as a result of the new contractual modality.

The most relevant regulations in relation to taxation are shown below:

- The formula for calculating advance payment of Income Tax is different from those of other companies.
- The percentage reduction of the income tax payment rate as a result of reinvestment is not allowed.
- With respect to the cost of financing and cost of transportation dealing with the use of the main pipeline, the only part deductible is that which corresponds to the barrels actually transported.
- In relation to the regulation that limits indirect expenses allocated from abroad to companies domiciled in Ecuador by their related parties, it includes technical and administrative services in the case of a taxpayer with exploration, exploitation and nonrenewable natural resources transportation contracts.
- In case the same contractor signs more than one contract for rendering hydrocarbon exploration and exploitation services, for purposes of income tax payment, it cannot consolidate the losses incurred in a contract with the profits originated in another.
- There is a tax on nonrecurrent revenues obtained by companies that have entered into contracts with the State for the exploration and exploitation of nonrenewable resources.
- Value Added Tax is not refunded in petroleum exporting activities.

## 3. ADMINISTRATIVE ASPECTS

The scheduling of intensive controls (assessments) is centralized at the National Tax Management Directorate and the controls are carried out by executing bodies at the Regional Directorates with the support and supervision of the National Areas.

Most of the private companies of the gas, petroleum, fuel and lubricant sector are part of the large taxpayers cadaster, which are controlled by teams specialized on the subject, beginning with the National Directorate as regards the determination of guidelines and supervisory efforts, and the regional offices where there are teams of auditors with specialized knowledge.

One of the advantages of this administrative structure is to aim at the unification of criteria in the control processes, as well as providing special training to the staff and the continuous improvement of decisions in administrative acts originating from the Internal Revenue Service.

An inconvenience posed by this structure is that in spite of aiming at the coordination of criteria, many times the Regional Areas issue their criteria directly, which causes the Tax Administration to express itself differently in relation to the same risk in two or more regional offices.

## 4. TECHNOLOGICAL ASPECTS

The Tax Administration has data bases with information provided by the taxpayer, as well as information reported by third parties (other taxpayers or public companies). This information is obtained through annexes, directly connected bases and taxpayer returns.

The information processing technological platform allows for storing 15 Terabytes of Information; that is, many millions of books. As for processing we have an ORACLE platform that ensures excellent response times in the transactional operations and undoubtedly the Internal Revenue Service (SRI) continues to have the largest data base in the country.

The SRI has acquired the SAP platform as part of its Business Intelligence and Information Management Platform, inasmuch as it is a modern platform that allows for incorporating the latest technological advances, as regards the use of the information with the highest demands of graphic interfaces and information services available for analyzing information. Additionally, the SRI is involving itself in the adoption of data mining tools for finding behavior patterns that are difficult to find only with human capability for data analysis.

There is also a National Tax Auditing System – NTAS, which endeavors to measure execution times and issue alerts upon conclusion of an activity. It also endeavors to be a repository of the working papers and the assessment documents of each case. This system is undergoing review and will be the subject of improvement in a second phase of operation, with a view to reducing its response time, storage capacity and including another type of information necessary for making decisions.

## 5. RISKS IDENTIFIED

The assessment processes carried out among taxpayers of the petroleum sector resulted in USD 971.7 million to be collected which represent the amounts generated in the corresponding processes. It must be clarified that most of the assessment process for 2009 and 2010 are yet to be concluded.

A summary is shown below:

| SECTOR | TOTAL |
|---|---|
| Fuel and lubricants | 74.272.613,08 |
| Gas extraction | 5.921.545,52 |
| Petroleum extraction | 891.530.447,58 |
| TOTAL | 971.724.606,18 |

## 6. PETROLEUM EXTRACTING COMPANY RISKS

It is important to point out that the risks described below correspond to the results shown by the petroleum companies or consortiums, according to the application of the participation contracts that are no longer in force. The results obtained according to the new contract for petroleum services modality have not yet been examined in assessment processes by the Tax Administration:

| RISK | TAX |
|---|---|
| Reference prices - Adjustments for difference in the selling price declared by the companies in the participation contracts. The Administration uses the reference price of the month prior to the date of shipping, while the company uses the current month's reference price. | Income |
| SHIP OR PAY: Companies pay the private transportation company the cost of the barrels reserved capacity, but not for what has been actually used.<br><br>The Internal Tax System Act provides that only those disbursements related to the generation of revenues subject to Income Tax in Ecuador should be deducted from the tax base, for which reason this expense would not be deductible.<br><br>On the other hand, the Tax Code states that the tax administration may analyze the true essence and economic nature of the transaction and not only its formal elements. In this regard, the following has been identified:<br><br>• The stockholders of the transportation company are its customers as well as some companies that belong to the same economic group.<br><br>• The company knew that the amount agreed could not be produced and much less transported.<br><br>• The largest loan which financed the construction of the pipeline was called subordinated debt and it was guaranteed with the commitment that each user (related company) would pay a fixed cost for a fixed number of barrels. | Income |

| RISK | TAX |
|---|---|
| Investment amortization: The regulation for the sector provides that “Investment amortization (…) will take place annually per unit of production starting on the fiscal year following that in which they were capitalized, according to the produced volume of the proven reserves (…)”<br><br>The amortization expense calculated by the Tax Administration differs from the value calculated by the contractors, mainly for the following reasons, according to the deductibility of expenses:<br><br>• Investment balances determined by the Tax Administration in previous years.<br>• Additions of investments not recognized by the Tax Administration. | Income |
| Transfer Pricing: The comparable uncontrolled price method was applied for the case of exports of nonrenewable resources – petroleum – through an international intermediary.<br><br>According to the information provided by the taxpayers, they do not provide financial or supporting information of the registry of intermediaries. Therefore, they do not comply with the requirement of the regulations as regards verifying that such intermediaries are really present in the territory of residence, as well as that the assets, risks and functions assumed by them are in keeping with the negotiated volumes of operation. It is necessary that the Taxpayer prove that the main activities of the intermediaries do not correspond to unearned income or commercial intermediation of goods from or to Ecuador, or with other members of the same economically related group.<br><br>Likewise, taxpayers do not provide information that may allow for visualizing that the operations with other members of the economic group related to the Consortium does not exceed 20% of the operations of the international intermediaries.<br><br>Therefore, in the export operations of the nonrenewable resources carried out through international intermediaries, one must apply what is provided in the regulations regarding transfer pricing, by showing differences between the comparable uncontrolled prices determined by transparent markets on the date of shipping the goods and those established between related companies. | Income |
| Nonrecurrent revenues: The tax regulation provides that when the companies that have signed with the state nonrenewable resources exploration and exploitation contracts have revenues generated from sales at prices exceeding those agreed or provided for in the respective contracts, they must pay 70% of those revenues to the State. | Nonrecurrent revenues |

Petroleum by-product company risks:

| **RISK** | **TAX** |
|---|---|
| Omission of revenues: Sales not reported by the taxpayer, risk identified in a crosscheck between the information reported by the state company and the company's accounting records. | Income |
| Excess depreciation: the company applied depreciation percentages on fixed assets, greater than those allowed by the tax regulation. | Income |
| Goodwill amortizations: the tax regulation does not allow the deductibility of amortizations that are not provided therein, goodwill amounts are not accepted as deductible. | Income |
| Difference in Inventories for surpluses not billed, according to report from the National Hydrocarbon Directorate, sale of subsidized gas as industrial gas. | Income |

Multinational company risks

| RISK | TAX |
|---|---|
| Use of treaty shopping to avoid Income Tax withholding at the source for payments abroad, through the misuse of double taxation agreements. | Income |
| Gross up: according to the provision of the Ecuadorian regulations, the taxpayer living in Ecuador is obliged to act as withholding agent; however, in case of considering pertinent to make the withholding at the source as required, the latter could not be considered as an Income Tax deductible expense. | Income |
| Undercapitalization: Existence of transactions between related companies, whereby funds are transferred in the capacity of credits which generate high interest amounts. It is worth noting that most of these "credits" fulfill all the legal formalities, although they have the following characteristics:<br><br>• High rates of interest<br>• They have no guarantees<br>• They do not have amortization tables<br>• Capital and interest payments are made according to the cash flow<br><br>According to the Tax Code, the taxable event includes two conjunctive elements that concur for its application: 1) the juridical essence and 2) the economic concept. As may be seen, it is imperative to observe the economic situations that actually exist with respect to the juridical form adopted. | Income |

## 7. FUTURE PERSPECTIVES

- The scarce resources available in the tax administration call for an in-depth consideration of a change of approach in intensive controls, a working pattern focused on a specialized risk matrix by economic sector.

- Another approach for the auditing processes implies a challenge for determining at the same time, a group of related taxpayers (business structure approach) who participate in the same transactions or in a value chain.

- Transfer pricing will be of greater application in the petroleum sector due to the economic change and globalization. Thus, it is a challenge for the tax administration to provide its auditors the necessary knowledge in order to carry out well-grounded actions in keeping with the taxpayer's economic reality.

- The new petroleum contracts for exploration and exploitation companies that currently only provide the corresponding service, while the State is the one exporting the raw material, implies an intensive analysis of the contracts and the possible tax risks that could arise therefrom.

- There has been a significant increase in the use of financial coverage instruments, for which reason it is important to analyze their tax impact.

## 8. CONCLUSIONS

- The petroleum sector is of great importance for the Ecuadorian economy, which has been evidenced in the results shown with respect to its contribution to national exports, GDP and budget financing.

- The change in the contracting modality of the petroleum exploration and extraction sector implies for the tax administration a challenge in the identification of new risks.

- Tax assessment in Ecuador has a sound legal base and internal guidelines for its application, as well as a specialized administrative structure in this sector and a technological platform that is being updated.

- The tax auditing process should be carried out with a tool for the analysis and follow-up of the controls undertaken, in order to generate the necessary information for decisionmaking at all

levels. For this reason, a review of the National Auditing System has been planned in order to implement structural improvements and promote its use.

- Specialized training for the tax auditing staff is important for the efficient performance of specialized audits in this sector.

- The companies in the petroleum sector have their own sectorial as well as tax regulations, which allows for a clear application in certain important fiscal aspects.

- The assessment processes have resulted in significant amounts of generated debt, which indicates the high level of tax risk existing in this sector.

## 9. RECOMMENDATIONS

- An in-depth analysis should be made of the impact of the new contracts with the petroleum extracting companies, in order to apply proactive controls to this sector, with a view to reducing the possibility of undertaking intensive control processes, in exchange for arriving at the timely modification of the taxpayer's behavior.

- Audits should be focused on a few of the most representative sectorial risks, linked to a specialized risk matrix.

- Consideration should be given to auditing a group of companies (business structure) that participate in the same transaction.

- It is important to focus on transfer pricing, since many multinational companies carry out transactions with their related parties which many times fail to comply with the arm's length principle.

- It is important to debug the tax information of taxpayers of the sector, in order to work on the basis of intensive crosschecks of the smaller taxpayers and thus expand control.

## INFORMATION SOURCES

1. Information from the Northern Regional Tax Audit Department.
2. Information from the Tax Control Department.
3. Information from the Business Intelligence Area.
4. Information from the Fiscal Studies Center
5. Information from the General Counseling Office
6. Information from the National Large Taxpayers Area

*Case Study*

*Topic 3.1*

# AUDIT OF THE GAS, PETROLEUM AND OIL SECTORS

**Heriberto Erik Ariñez Bazan**
Executive Chairman, a.i.
National Tax Service
(Bolivia)

***Contents:*** *1. Background.- 2. Tax structure of the hydrocarbon production chain .- 3. General examination procedure.- 4. Tax auditing of hydrocarbons sector.- 5. Cases.- 6. Conclusions*

## 1. BACKGROUND

The structural reforms undertaken according to Law Nº 1182 of Investments of September 17, 1990 and Law N°1689 on Hydrocarbons, of April 30, 1996, provided an appropriate scenario for increased private investment in hydrocarbon activities, inasmuch as they established a legal, regulatory and taxation framework for this sector, with internationally competitive conditions for attracting foreign capitals to Bolivia.

By sovereign mandate of the Bolivian people in response to question number 2 of the Referendum of July 18, 2004 and according to the application of Article 139 of the State´s former Political Constitution, ownership is recovered by the Bolivian State of all hydrocarbons at Boca de Pozo. Through Yacimientos Petrolíferos Fiscales Bolivianos (YPFB), the State exercises its proprietary right over the totality of hydrocarbons. Likewise Law Nº 3058, of May 17, 2005, approved the new Hydrocarbons Law which provided for the Bolivian State's recovery of direct, inalienable and imprescriptible ownership of hydrocarbons, as well as the regulatory framework for investors.

On May 1st, 2006, through Supreme Decree N° 28701, the Executive Body, through the application of Law Nº 3058 nationalized the country's hydrocarbon natural resources, thereby ratifying the State's role in the control and management of production, transportation, processing, storage, distribution, commercialization and industrialization of hydrocarbons in the country. This situation was confirmed and ratified on February 7, 2009 through Articles 359, 360 and 361 of the State's

new Political Constitution.

In view of this new situation arising in 2006, those who would have signed Shared Risk Contracts for carrying out Exploration, Exploitation and Commercialization activities, and would have obtained licenses and concessions according to Hydrocarbons Law Nº 1689 of April 30, 1996, obligatorily, as per Article 65 of Law Nº 3058, would have to be adapted to the three types of oil contracts (shared production, operation and association).

Thus, in October 2006, the Bolivian State opted for the Operation Contract model, whereby YPFB obtains revenues for the monthly sale of hydrocarbons delivered by the petroleum companies, deducting from said amount the costs of transportation and commercialization of hydrocarbons. There are currently 41 contracts in force for carrying out exploration and exploitation activities.

In Bolivia, natural gas and petroleum between 2011 and 2012 increased 13.8% and 15.5% respectively, while the production of PLG was reduced due to a lower production in refineries (see chart 1). However, this situation has been modified, inasmuch as it is anticipated that this product will be exported as of September 2013:

**Chart 1. Production of natural gas, petroleum and liquefied petroleum gas (LPG)**
**2011 and 2012**

| | Gas natural[1] (Mm3/día) | | Petróleo [2] (MMBbl/día) | | GLP [3] (Tm/día) | |
|---|---|---|---|---|---|---|
| | 2011 | 2012 | 2011 | 2012 | 2011 | 2012 |
| Promedio | 43,48 | 49,46 | 44,43 | 51,32 | 898,75 | 895, |

Fuente: YPFB. Boletín Estadístico 2012 (www.ypfb.gob.bo)

(1) Producción en punto de fiscalización. Valores actualizados en febrero de 2013.

(2) Pruducción certificada de petróleo, condensado y gasolina natural. Valores actualizados en febrero de 2013.

(3) Volúmenes producidos en planta y en refinerías. Valores actualizados en febrero de 2013.

As regards taxation, the hydrocarbon sector is very important in the national economy. Of the 100 companies that pay most taxes in Bolivia, 15 correspond to the sector whose payment amounted to Bs18.912.- million in 2012 (see chart 2), thus representing 50.50% of the total collection of taxes generated at the national level of Bs.37.460.47 million, and which data reflect the need for a specialized area or sector in charge examining companies Upstream (search, extraction, processing and adaptation of oil and gas) as well as Downstream (Petroleum refining, commercialization, services and transportation).

**Chart 2. Tax amounts paid by companies of the hydrocarbons sector**
**2012 Period (In millions of Bs)**

| PUESTO | CONTRIBUYENTE | DEPARTAMENTO | TOTAL 2012 | % de Part. 2012 |
|---|---|---|---|---|
| 1 | YACIMIENTOS PETROLIFEROS FISCALES | LA PAZ | 13,422.2 | 35.8 |
| 2 | YPFB REFINACION S.A. | SANTA CRUZ | 2,381.0 | 6.4 |
| 4 | YPFB ANDINA S.A. | SANTA CRUZ | 807.1 | 2.2 |
| 5 | YPFB CHACO S.A. | SANTA CRUZ | 575.1 | 1.5 |
| 8 | PETROBRAS BOLIVIA S.A. | SANTA CRUZ | 401.2 | 1.1 |
| 14 | GAS TRANSBOLIVIANO SA | SANTA CRUZ | 258.4 | 0.7 |
| 15 | BG BOLIVIA CORPORATION SUC. BOLIVIA | SANTA CRUZ | 235.7 | 0.6 |
| 16 | TOTAL E & P BOLIVIE SUCURSAL BOLIVIA | SANTA CRUZ | 220.9 | 0.6 |
| 18 | REFINERIA ORO NEGRO S.A. | SANTA CRUZ | 182.2 | 0.5 |
| 24 | PLUSPETROL BOLIVIA CORPORATION SA. | SANTA CRUZ | 134.8 | 0.4 |
| 25 | YPFB TRANSPORTE S.A. | SANTA CRUZ | 107.0 | 0.3 |
| 47 | REPSOL E&P BOLIVIA S.A. | SANTA CRUZ | 57.3 | 0.2 |
| 55 | VINTAGE PETROLEUM BOLIVIANA LTD | SANTA CRUZ | 50.5 | 0.1 |
| 66 | PETROBRAS ARGENTINA S.A SUCURSAL BOLIVIA | SANTA CRUZ | 42.2 | 0.1 |
| 79 | PAE E Y P BOLIVIA LIMITED SUC. BOLIVIA | SANTA CRUZ | 37.4 | 0.1 |
| **Recaudación total Hidrocarburos** | | | **18,912.9** | **50.5** |

Source: SIN – 2012 Annual Report.

Note: To date, the number of companies in the entire sector is 93, of which 48 are involved in exploration, 2 in refining, 36 in services (these are the companies that provide services to the hydrocarbon taxpayers), 6 in transportation and 1 in commercialization (YPFB wholesale commercialization). It does not include service stations or gas distributors through networks.

## 2. TAX STRUCTURE OF THE HYDROCARBON PRODUCTION CHAIN

According to Article 31 of Law Nº 3058, the hydrocarbon activities are classified as follows:

a. Exploration;
b. Exploitation;
c. Refining and Industrialization;
d. Transportation and Storage;
e. Commercialization;
f. Distribution of Natural Gas through Networks

Within the technical framework of operations these hydrocarbon activities are also defined as:

- UPSTREAM, comprises all hydrocarbon exploration, drilling and production activities in Bolivia.

- DOWNSTREAM comprises all activities that involve refining, industrialization, transportation, internal commercialization, distribution, logistics, import and export of natural gas, petroleum and its by-products.

According to the provisions of Law N° 843 and regulatory standards, individual sor corporations will be subject to the following general tax system:

- **Value Added Tax (VAT):** Encumbers the sale of properties located or placed in the national territory, work contracts, rendering of services and any other capabilities, regardless of their nature and definitive imports. A 13% rate is applied according to the provisions of Article 1 to 4 and 15 of Law Nº 843.

  In the hydrocarbon sector it applies to the sale of petroleum, natural gas, liquefied petroleum gas ad by-products, as well as the administration services, lease of plants and machineries and rendering of technical services.

- **Transactions Tax (TT):** It is applied in the national territory to commerce, industry, profession, occupation, business, lease of properties, works and services or any other activity - profitable or not - regardless of the nature of the individual rendering the service, as well as gratuitous transactions that imply the transfer of ownership of properties, real estate and rights, with a 3% rate as provided in Article 72 to 75 of Law Nº 843.

  In the hydrocarbon sector taxes are applied to such activities as the transportation of hydrocarbons, either through ducts or tanks, refining, distribution and commercialization. Exempt from this tax is the purchase of hydrocarbons and/or by-products in the internal market intended for export, provided that the aforementioned products would not have undergone a transformation process.

- **Company Profit Tax (CPT):** The source principle is applied. It encumbers at the 25% the profits resulting from the Financial Statements of the companies at the closing of each annual period, using as general rule, the deductibility of expenses incurred in the country or abroad which are related to the taxed activity and support with original documents, as provided in Article 36 to 39 and 50 of Law Nº 843.

- **Company Profit Tax – Beneficiaries from Abroad (CPT-BA):** It is only applied when income from Bolivian source is paid, sent or credited to beneficiaries abroad by way of interest, yields or profit obtained. It is also applicable for the rendering of services: consultancy, counseling of every type, technical assistance, professional and research services carried out from or abroad, at the rate of 25% applied to 50% of the amount paid, according to Article 51 of Law Nº 843.

Those who devote themselves to the hydrocarbon business and considering the economic activity, in addition to the taxes indicated in the previous paragraph will be subject to the following taxes:

- **Special Tax on Hydrocarbons and their By-Products (STHC),** which encumbers the import and commercialization in the internal market of hydrocarbons and their by-products at specific rates per unit of measure updated annually, as provided in Articles 108 to 113 of Law Nº 843.

  Internally produced or imported are the hydrocarbons and their by-products that result from any process involving production, refining, mixture, aggregation, separation, recycling, and adaptation, processing units (platforming, isomerization, cracking, blending and any other denomination) or every other form of conditioning for transportation, use or consumption.

- **Direct Tax on Hydrocarbons (DTH)** encumbers the production of hydrocarbons throughout the national territory. The rate is 32% of the total of hydrocarbon production measured at the point of examination and which is applied in a direct, non-progressive manner to 100% of the volumes measured at the examination point in the first stage of commercialization, as provided by Article 53 to 55 of Law Nº 3058.

The entire chain is subject to the general taxation system taxes with exemptions, as well as to the specific ones of the sector (see charts 3 and 4):

## Chart 3. Taxes on hydrocarbon sector according to phase of operation and activity

| PHASE | ACTIVITIES | TAXES OF A GENERAL NATURE | SPECIFIC TAXES |
|---|---|---|---|
| UPSTREAM | Exploration | VAT, TT, CPT, CPT-BA (1) | |
| | Exploitation | | |
| DOWNSTREAM | Refining and Industrialization | VAT, TT, CPT, CPT-BA (1) | STHC (2) |
| | Transportation and Storage | | |
| | Commercialization | | STHC (2) , DTH (3) |
| | Distribution of Natural Gas | | |

Source: Self-prepared.

(1) The CPT –BA is only applicable in case of remittances abroad.

(2) The STHC is applied to wholesale import and commercialization in the internal market.

(3) YPFB, the state enterprise is subject to this tax through the fulfillment of the generating event established when measuring the production of hydrocarbons in its first stage of commercialization at the examination point, in accordance with Article 54 of Law Nº 3058.

## Chart 4. Taxes of the hydrocarbon sector according to structure

| Tax | Rate | Tax Base | Exemption | Regulation |
|---|---|---|---|---|
| VAT<br>Value Added Tax | 13% | Invoiced sales less purchases related to taxed activity | - | Law Nº 843, Articles 1 to 4 and 15 |
| TT<br>Transaction Tax | 3% | Gross Revenues | The purchase of hydrocarbons intended for export | Law Nº 843, Articles 72 to 75 |
| CPT<br>Company Profit Tax | 25% | Net Profit on Financial Statements | Industrialization operations free from payment for a period of 8 years. | Law Nº 843, Articles 36 to 39 and 50 |
| CPT-BA<br>Company Profit Tax - Beneficiaries Abroad | 25% | 50% on presumptive profit | - | Law Nº 843, Article 51 |
| DTH<br>Direct Tax on Hydrocarbons | 32% | Production of hydrocarbons throughout the national territory | Volumes of gas intended for social and productive use of natural gas in the internal market | Ley Nº 3058, Articles 53 to 57 |
| STHC<br>Special Tax on Hydrocarbons and their By-Products | Specific rate per liter of petroleum-derived product | Import and commercialization of hydrocarbons and their by-products in the internal market. | - | Law Nº 843, Articles 108 to 114 |

Source: Self-prepared.
(*) It is in the process of regulation for its application.

## 3. GENERAL EXAMINATION PROCEDURE

Tax audit is a systematic verification process whose purpose is to determine whether the accounting standards have been correctly applied, if the tax legal regulations have been correctly interpreted and applied and if, accordingly, the taxpayer returns have been adequately prepared.

The examination procedure is an administrative process which establishes the efficient and timely beginning and conclusion of the assessment processes in their different modalities, according to Law Nº 2492 of the Bolivian Tax Code.

The National Tax Service, by virtue of the powers stipulated in Article 66 of the Bolivian Tax Code, as regards control, checking, verification, examination and investigation counts on the following examination process modalities (see chart 5).

**Chart 5. Examination Process Modalities**


To carry out an examination, there is a standard procedure whose examination order, assignment of officials, documentation request, verification and analysis will vary according to the modality applied, as shown below:

- Preparation of tax intelligence studies for identifying possible examinations.
- Generation of examination order, following acceptance of the request for examination order report an assignment of officials.

After the identification of the sector, item and taxpayer, the Examination Department will proceed with the following schedule:

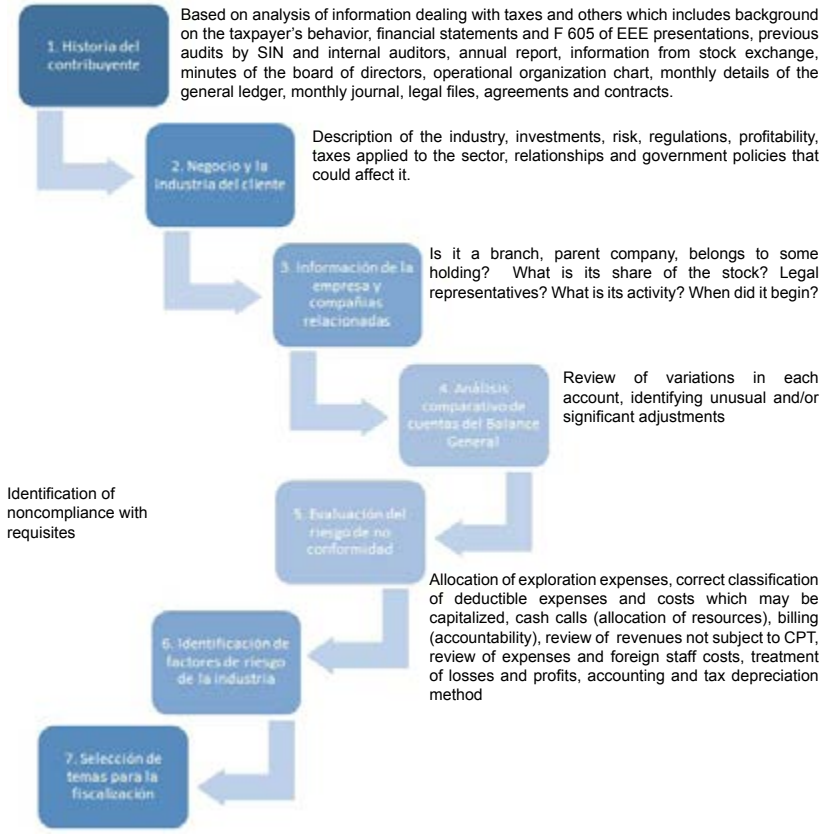
a. Issuance of Examination or Verification Order.
b. Notification to the taxpayer along with the Order, including the Request for Information with deadlines.
c. Receipt of documents requested
d. Verification and analysis of documents (Office review and/or Field Work).
e. Determination of results and objections raised.
f. Preparation of reports

   - Issuance of Report and Assessment Resolution for Nonexistence of Tax Debt on not finding objections or total payment (omitted tax, interest, fines and sanction, if appropriate).
   - Issuance of Report and Intervention Resolution in case payment of the debt were omitted or partially made.

g. Notification to the taxpayer with the Intervention Resolution.
h. The taxpayer has a thirty (30) day unextendable term as of the day of the notification of the Intervention Resolution to pay or submit the objections he may deem convenient.
i. Following that Term, the Assessment Resolution is issued and the latter becomes the Tax Execution document which is notified to the taxpayer.

Based on the detailed procedure, the particular aspects of examination of the hydrocarbons sector are carried out according to a strategic analysis (see chart 6):

**Chart 6. Strategic analysis of the sector**




## 4. TAX AUDITING OF HYDROCARBONS SECTOR

Currently, the YPFB state company is dependent on the Large Taxpayers Management Office of the Department of La Paz. Up till now, the most important task is the receipt and payment of DTH[1], conciliations and rectifications, in addition to having been subjected to internal verifications.

1 *Although the DTH in strict terms corresponds to Downstream operations, audits are carried out in the production stage considering that one must 1) Compare the amount produced according to the examination, with the amount certified by the authorized entities; 2) Verify the payment of the DTH according to the operation contracts; and 3) Verification of the annexes to the tax payment, in the production of petroleum, natural gas and PLG of plants.*

The rest of the companies of the sector are distributed between the large taxpayer management offices of the departments of Santa Cruz and Cochabamba, which are in charge of ensuring their due compliance with their tax obligations.

### 4.1. Audits of Upstream operations

This process covers the segment of the industry which is in charge of hydrocarbon extraction (Petroleum, Natural Gas and PLGL from Plants), which consists of exploration, drilling, exploitation up to its delivery in the refinery, processing or cracking plants for beginning the industrial process. The taxes applied in Upstream operations are VAT, TT and CPT.

In Tax Auditing processes an analysis is made of the tax generating event which is completed at the examination point. Subsequently, the main objective is the determination of the revenue received in accordance with the price established and the amount produced, for which purpose reconstruction of the productive process techniques are applied according to the inputs required and/or fixed assets used (production capacity).

Likewise, there are specific technical as well as legal standards in the petroleum sector's accounting records.
Thus, the following techniques are mainly applied in the accounting and tax verification of Upstream operations:

**For VAT**

1. Review of the holder's compensation which consists of the recovery of costs; that is, labor, materials, and depreciation of fixed assets, among others.
2. Review of the documents related to the production of petroleum and gas.
3. Review of purchases, making sure that they are related to the taxed activity, that they comply with the formalities and that they are duly supported with reliable means of payment according to the rules.

4. Compare purchases and sales with third-party informants.

**For the TT**

1. Compare the amount sold in the internal market with the amount produced to identify undeclared revenues.

**For the CPT**

1. Compare the amount sold in the internal and/or external market with the amount produced, to identify undeclared revenues.
2. Identification of accounting errors, which generates expense misappropriations.
   - Nondeferral of an expense
   - Undue allocations
   - Depreciation of fixed assets according to the specific tax standards in force.
3. Identification of operations excluded from accounting process
   - Simulation of losses
   - Concealment of profits
   - Simulation of liabilities
   - Concealment of assets (Accounts Receivable).
4. Review of the holder's compensation, which consists of the recovery of costs; that is, labor, materials, and depreciation of fixed assets, among others.
5. Review of deductible and nondeductible expenses for the determination of the tax base.

### 4.2. Audits of Downstream operations

The scope of the tax audit is determined in the tax intelligence study. It comprises taxes, periods and items to be reviewed according to the modalities established under item 3.

In Downstream operations the following activities must be reviewed:
a. Refining and Industrialization;
b. Transportation and Storage;
c. Commercialization;
d. Distribution of Natural Gas through Networks

#### 4.2.1 Refining

Refining is a process that converts petroleum into products generically called carburants, liquid or gas fuels, lubricants, grease, paraffin, asphalt, solvents and other subproducts generated from said processes.

In the refineries one can review the following taxes: VAT, TT, CPT, CPT-BA, RC-VAT and STHC, according to specific procedures for each of them.

### 4.2.2 Retail commercialization

They comprises service station activities and sale of lubricants, of products originating from petroleum generically called carburant, liquid or gas fuel, lubricants, grease, paraffin, asphalts solvents and other subproducts generated by said processes in retail commercialization with the end consumer.

The following taxes may be examined in this activity: VA, TT, CPT, CPT-BA, RC-VAT, according to specific procedures for each of them.

### 4.2.3 Transportation of hydrocarbons

Involves any activity for transferring or taking from one place to others, hydrocarbons or their by-products by means of pipes, using for such purpose various means and auxiliary facilities, which include the necessary storage for this activity and excludes the distribution of natural gas through networks.

The following taxes may be examined in the transportation of hydrocarbons: VAT, TT, CPT, CPT-BA, RC-VAT, according to specific procedures for each of them.

### 4.2.4 Some additional techniques for downstream review

In the case of STHC one verifies:
1. If the tax was paid upon leaving the refinery.
2. The types of products and amounts refined according to the reports submitted to the regulating entities.
3. Consistency between the amount purchased and amount refined.
4. The turnover of the products refined and sold
5. The amount imported and taxes paid.

In the case of VAT one verifies:
1. The sales, considering the volumes purchased, transported, reported to the pertinent authorities with respect to sales invoiced and declared.
2. That invoicing corresponds to the period of commercialization and/or measurement (continuous services).
3. The purchases, ensuring that they are related to the taxed activity, that they comply with the formalities and supported with reliable means of payment according to the regulations
4. Compare the purchases and sales with third-party informants.
5. When verifying VAT one will take into account particular aspects in invoicing: tax debit and tax credit of the purchaser

a) The Special Tax on Hydrocarbons (STHC) is shown separately in the invoice. The Price of the product and STHC = Total invoice, the seller pays the tax debit on the total price, without considering the STHC.

b) The VAT Tax Credit is calculated on the basis of the total of the invoice issued by the Refinery (including the ISTHC).

In the case of TT one verifies:
1. If the tax rate is applied on the margin (sales less purchases).

In the case of CPT one verifies:
1. The revenues, considering the incidence of sales review, undeclared sales are revenues subject to CPT. One must also verify the taxable and nontaxable revenues declared by the taxpayer.
2. Expenses are related to taxed income, supported with original commercial, accounting and financial documents which comply with the tax regulations (deductible and nondeductible expense).
3. Bank transactions for sending remittances abroad and their corresponding withholding of CPT-BA.

## 5. CASES

### Case 1 invoices with taxation events from other period

The analysis of invoices supporting the tax credit of a production company detected invoices that were issued by the company 'Servicios Bolivia" on October 24, 2002 and March 7, 2003, but for taxable events from a previous management period, i.e. in 1998; these invoices were related to payments for the leasing of a cryogenic facility in April, May and June 1998, as well as the cost of imports, paid by the production company to a "Services Company" based in Houston USA, through bank transfer, without making the corresponding CPT withholding to beneficiaries abroad; the payments made to the American company were supported by international invoices 980017a, 980017b, 980017d, 980018a and 980018b.

In this regard, it was reported that:

The services were provided by "Servicios Bolivia", but billed by "Services Company"; the payments were made by bank transfer directly to bank accounts of "Services Company", without withholding the profit tax (CPT) for beneficiaries abroad.

On base of the audit by the external auditors and given the lack of withholding of the CPT-BE profit tax in the corresponding payment; after analyzing the situation and in order to obtain tax advantages, the taxpayer decides to return bills initially received from “Services company”, to replace them with local invoices issued by “Bolivia services” which apparently allows to benefit from the tax credit.

Another test that shows the intention of the taxpayer of taking advantage of the tax credit generated by local invoicing is that they also canceled to “Servicios Bolivia” the amount corresponding to the IT tax that the supplier had to pay.

The production company reports that according to the lease contract of the cryogenic plant, “Servicios Bolivia” should have been invoiced locally. Later, because of claims made by the production company, this situation was remedied by issuing these invoices, which comply with the main requirements to be valid for the calculation of the tax credit, according to the article 5 of law No. 843.

In addition the taxpayer mentions that the taxation event for services is created at the time of their delivery or from the time of their payment, as a result two aspects are present: i) the observed invoices relate to a service that at the date of invoicing was in progress and which execution had not been completed, as shown in the financial lease delivered to the audit team; and (ii) Although there was a partial payment of the price, the supplier did not invoice in due time.

The taxpayer argues that the amounts paid to the company “Services Company” based in Houston USA, are for services that were in progress at that time. In this regard, we note that the service referred to was a financial leasing contract and payments for the importation of equipment; therefore under the tax legislation for financial lease, the taxable event is completed at the **due date of each installment**, law N ° 843 article 4; in the case of imports, the taxable event is concluded **when the import is completed**, law 843 article 4; It is concluded that the leasing fees were overdue and that imports service already had been completed, facts that the taxpayer knew when he made the payment to the foreign company without making the corresponding withholding.

Therefore, it is not that production company, four years later, in an attempt to address its lack of withholding tax sui-BE at the time, take a tax credit by a fact that originally according to the background was having made withholding sui beneficiaries from the outside. _

In this respect the Supreme Decree N ° 24051, article 34 (beneficiaries abroad) stipulates: “as set out in article 51 of the law N ° 843 (published in 1995), who paid, credited, or deliver income of Bolivian source to beneficiaries abroad detailed in the article 4 of this regulation and 19° and 44° of the law N ° 843 (1995 ordered text)”They shall withhold and pay until the fifteenth day (15) of the month following the one in which there taxable facts took place, the aliquot general of the tax on the taxable net income equivalent to fifty percent (50%) of the total amount paid, credited, or delivered.

Law No. 843, article 4, subsection e) in the case of leasing, the taxable fact occurs at the due date of the expiration of each installment.

Law No. 843, article 46, the CPT tax has an annual basis and will be determined at the end of each period on prescribed dates, to the effect, revenues and expenses will be considered from the current year in which they occur.

Regarding the present concept, the departmental Court of Justice of Santa Cruz has at first instance in favor of the tax administration, and a final decision from the of the Supreme Court is pending.

**Case 2 Overhead incomes not invoiced**

From the review of the accounting records and supporting documentation provided by Enterprise oil, it was determined that during the period subject to audit, the taxpayer received (cash) revenues that were paid into the following bank accounts: 5730012813 Bank X, checking, USD - C5 and 5730003312 CHASE MANHATTAN, current account, dollar (USD) - C4, by concept of overhead charged to partners of the oil blocks operated by the taxpayer oil company, corresponding to the periods audited and other periods prior to this, however the respective invoices were not issued.

In spite that the taxpayer Oil company has an accounting Manual (which is shown here) that determines the accounting registration of the overheads “expenses for the beneficiary oil block” as well as “income actually received by the services provided to members by the operator” , the respective invoices for amounts reported in bank accounts were not issued.

As it can be observed, in the following description obtained from the Accounting procedures Manual of the taxpayer accounts operations, the income account 75.903.100 OVERHEADS RECOVERY AGREEMENTS”, shall be paid (log entry) by the amount of the

overheads invoiced to the partners (partners of the blocks operated by the taxpayer), charged to the checking accounts (bank account, cash).

Whereas the overheads are corporate administration costs and support provided by the **oil operator**, for services delivered**, income** corresponding to these costs **was received**; regardless the subject that delivers them (directly or via third parties), the cash received by the taxpayer Oil company, represent revenue taxed by value added tax and Transaction Tax.

The taxpayer mentions that the revenues do not correspond to any service but represent **the accounting for reimbursement that partners make to the oil operator**, in this case to the oil company and which therefore does not correspond his billing.

On the other hand, an incorrect interpretation of the accounting manual that clearly referred to the account 75.903.100 as OVERHEADS RECOVERY ACCORDING TO AGREEMENTS, identification, regardless of the text that goes with it, shows its essential feature (recovery/refund) and, more importantly, is consistent with the economic reality of operations that are none other than REIMBURSEMENTS for expenses incurred by the company as operator regarding the oil administration.

As mentioned, the taxpayer States that revenues from reimbursement (overhead) are not taxable income because are not included in the object of the VAT, provided for in article 1 of the law No. 843, and are expressly excluded from the object of the tax to the transaction (IT) in accordance with article 4 ° of Supreme Decree No.. 21532 subsection. (b).

It also indicates that the company as operator of a risk-sharing agreement does not provide service to the holding or the other partners because it is part of it. This situation would mean that the company would provide services to itself every time that the risk contract does not mention a legal entity, the objective of the operator is not to offer lucrative services but generating profits so that they are distributed to all shareholders, by which, non-operating partners refund all of the administrative and operational costs incurred by the operating partner.

(For this purpose, subsection b), article 1 of the law 843 indicates that the value added tax (VAT) affect any contracts for works, services and any other activity performed in the national territory.

In the case of the Transaction TAX (T), in accordance with article 72 of the law, the transaction tax includes, in the national territory, trade, industry, profession, trade, business, rental, goods, of works and services or any other activity - lucrative or not - whatever the nature of the subject that lends.

Therefore, from the analysis and assessments carried out by the taxpayer, the following is established:

The taxpayer indicates that the installments paid on the following accounts: 5730012813 INDUSTRIAL BANK, CHECKING ACCOUNT, USD - C5 and 5730003312 CHASE MANHATTAN CHECKING ACCOUNT, (USD) - C4 do not correspond to any income, they represent the accounting for reimbursement that partners make to the oil operator. In this regard, they explained as follows: the installments made in the indicated bank accounts (which correspond to the oil company) come from transfers of funds from the accounts of Bank of each of the holding, i.e., in the holding accounts represent expenses and oil company accounts represent the income (cash paid).

The funds received by the oil company in the accounts: 5730012813 INDUSTRIAL BANK, CHECKING ACCOUNT, USD - C5 and 5730003312 CHASE MANHATTAN CHECKING ACCOUNT, (USD) - C4, represent income, since they also are funds delivered by each of the oil partners to the oil company via funds transfer.

The taxpayer does not present any documentation to demonstrate the support of expenditures made and registered on the account 6290500012 OVERHEAD- OPERATOR, however he believes to be entitled to reimbursement, when the expenses incurred by the subsidiaries operated by the oil company, were already registered and appropriate to different spending accounts.

The taxpayer claims that the overheads represent REIMBURSEMENTS for expenses incurred as operator for the administration of the oil facility, however, the absence of invoices and documentation to demonstrate the various expenses incurred, demonstrates the delivery of administrative services by the operator to the oil holding.

The account 6290500012 OVERHEAD-OPERATOR - that registers the overheads expenses has been considered deductible for purposes of the CPT, since precisely they constitute corporate management expenses and the support provided by the operator of an oil block, i.e. it is not a mere explanation from Accounting Manual of the taxpayer.

It is important to mention that this case was discussed by the Tax Superintendence and that two instances have ruled in favor of the tax administration, the case being currently analyzed by the Supreme Court of Justice.

**Case 3 Payments made for services received from Headquarters**

As a result of the review to the documentation submitted in support of the expenses registered in the ledgers of the taxpayer company X - Bolivia, expenses were identified supported by invoices issued by company X - Europe, for provision of services by the expatriate staff (residents), re-invoicing of expenses incurred by company X-Bolivia, specialized technical assistance in geology, seismic, and reserves services, etc., however these expenses to date do not have the corresponding CPT-BE withholding.

The taxpayer says that, as a general rule, the withholding of the CPT-BE for these services and interests should be made under Bolivian law. However, since the payments are made by a Bolivian company in favor of a company domiciled abroad, the mandatory application of the Convention to avoid the double international taxation (DTC) signed between the two countries, ratified by the law 1655 of 31 July 1995 applies. For this purpose, for a correct interpretation and application of the referred DTC and with the purpose of clarifying the confusing and inadequate criteria that have been generated to date, it is imperative to explain the following basic concepts of international tax law.

The first basic step to implement a DTC is to establish who are the “parties” to which applies the DTC. The answer is found in article 1 of the DTC, which indicates that the Convention applies to parties who are residents of one or both Contracting States. In our case DTC with the European country establishes that it applies to individuals or legal entities resident in one or both States.

This means that for the application of the DTC, it is essential to demonstrate that the company X-Europe is registered in Europe and that the company X-Bolivia is registered in Bolivia. The answer to the first question is in the charge view, where it is established that company X-Europe is a European company, which does not require additional documentation. The answer to the second question is proven with the mere existence of the number of identification tax (NIT) of the company X-Bolivia, certifying it as a branch and an independent taxpayer of the Bolivian State.

As a result, both companies may invoke the application of DTC signed between Bolivia and the European country to avoid international double taxation on incomes they generate in their business operations.

All DTC is a distribution of tax powers between the Contracting States to avoid international double taxation. There is a general rule about company profits, which applies when there are no specific rules about incomes types separately regulated in the following articles. For example, if there is a separate article on interest in the DTC, its application will have priority on article VII referred to profits in general.

This brief explanation helps to understand that the DTC favors the residence principle as a general rule, noting first that company revenues are recorded in the country of residence. That means the first part of paragraph 1 of article VII, which says: “the benefits of a company in a State will only be taxable in this State”. For example, if a European company gets revenue in Bolivia, this only can be taxed by the European country.

The first exception to this general rule occurs when the company performs operations in the other State through a permanent establishment. This means that if the foreign company get these incomes by operation of a permanent establishment located in Bolivia, the right to tax such income belongs logically to Bolivia and no longer to the European country.

Subsequent to these allegations the taxpayer accepted and proceeded to the required adjustments.

## 6. CONCLUSIONS

With the experience gained in the implementation of control processes, we can ensure that audits results have improved substantially, providing higher revenues, as well as better legal, accounting and technical support in the observations made.

Due to the high number of transactions from companies domiciled in the country with foreign companies, whether headquarters, subsidiaries, etc., we are currently working on amendments to the tax legislation, to make this more practical and appropriate in the development of audits to the oil companies.

Due to the expansion of the transnational corporations operating in the oil industry, with foreign companies, either unrelated or related parties, the control of companies that perform this type of transactions, the

increase of operations with foreign partners and the transfers costs, one of the main challenges for the Administration today is the control of companies performing this type of transactions.

*Case Study*

*Topic 3.1*

# AUDIT OF THE GAS, PETROLEUM AND OIL SECTORS

**Fredrik Aksnes**
International Director
General Directorate of Taxes
(Norway)

***Contents:*** *1. Auditing of the petroleum sector in Norway. 1.1. The importance of the Petroleum sector in the Norwegian economy. 1.2. Legal framework for the oil companies. 2. Organization of the tax audit activity. 2.1. The Norwegian petroleum taxation system. 2.2. Norm price. 2.3. Audit of the oil companies. 3. Transfer pricing issues at the oil taxation office. 3.1. Intra –group sales of petroleum products. 3.2. Intra-Group insurance companies ("captives"). 3.3. Intra-group loans. 3.4. Intra-Group services ("Overhead"). 3.5. Desk vs. Field audits. 4. Future challenges. 5. Conclusions.*

*Presentation PPT*

## 1. AUDITING OF THE PETROLEUM SECTOR IN NORWAY

### 1.1. The importance of the Petroleum sector in the Norwegian Economy

As many of you probably know the Petroleum sector plays a predominant role in the Norwegian economy. Oil and gas is by far Norway's single most important export article (47%), contributes by around one fifth to the Norwegian GDP, consumes one fourth of total investment about the same size as its contribution to the government's revenues. In 2010 Norway was the seventh largest oil exporter in the world and the second largest gas exporter (after Russia). The development of new discoveries should create the largest possible value for the nation. It will therefore also provide local and regional ripple effects.

But since the audience here consists of tax people and not macroeconomist I will focus on the Government's revenues from the petroleum activities, and how this is collected. But before entering this subject I must present the framework and organization of the petroleum sector in Norway and also provide some information on how

the taxation of oil companies and related activities is organized within the Norwegian Tax Administration (NTA).

### 1.2. Legal framework for the oil companies

The Norwegian Petroleum Act (ACT of 29 November 1996) contains the general legal basis for the licensing system governing Norwegian petroleum activities. The act confirms that property rights to the petroleum deposits on the Norwegian continental shelf as vested in the State. Official approvals and permits are necessary in all phases of the petroleum activities, from award of exploration and production licenses to plans for development and operation and plans for field cessation.

## 2. ORGANIZATION OF THE TAX AUDIT ACTIVITY

Different parts of NTA are involved in different phases of the petroleum exploitation

Before any production, transportation and processing of petroleum can take place one must of course find the oil and gas. Exploration wells have to be sunk to verify the presence of significant volumes of oil and, given the cost of drilling; it has become imperative to minimize the risk of repeatedly ending up with dry wells. These highly specialized and often rather small companies are not assessed at the Oil Taxation Office (OTO) but at the Central Office of Foreign Tax Affairs (COFTA).

As long as they are not an intra - group company.

COFTA also assess the companies involved at construction of the rigs, supplying the rigs (services, catering etc.). Some of the major challenges COFTA faces are to make decisions regarding whether some form of activity or service delivery is to be considered as having taken place through a permanent establishment and therefore liable to pay corporate tax to Norway. Transfer pricing issues in the cases when the company operating on the Norwegian Continental Shelf receives services and funds from companies within the same group is another important working area. COFTA is also responsible for the registration of employees who are only temporarily working in Norway in petroleum related activities on the continental shelf. In the following I will not cover COFTA's role in the Norwegian oil taxation system any further, since the big oil tax money is collected elsewhere, that is at the Oil Taxation Office.

### 2.1. The Norwegian petroleum taxation system

The petroleum taxation system is based on the rules for ordinary corporate taxation, but specified in the Petroleum Taxation Act (Act of 13 June 1975). Due to the extraordinary profit associated with exploiting the petroleum resources, an additional special tax is levied on this type of commercial activity. The ordinary tax rate is the same as on land 28%. The special tax rate is 50%.

When one calculates the basis for ordinary and special tax, investments are subject to straight-line depreciation over six years from the year they were incurred. Deductions are allowed for all relevant costs, including costs associated with exploration, research and development, financing, operations and removal. Consolidation between fields is allowed.

To shield normal return from special tax, an extra deduction is allowed in the basis for special tax, called uplift. This amounts to 30% of the investments (7, 5% per year for four years, from and including the investment year).

### 2.2. Norm price

The production from the Norwegian continental shelf is largely sold to affiliated companies. To assess whether the prices set between affiliated companies are comparable to what would have been agreed between two independent parties, the Petroleum taxation act states that norm prices can be stipulated for use when calculating taxable income for the purpose of the tax assessment.

The Petroleum Price Board sets the norm price, which aims to reflect what the price could have been sold for between independent parties. This system applies to certain grades of crude oil and NGL. For gas, the actual sales prices are used as the basis.

### 2.3. Audit of the oil companies

The tax assessment period 1. May – 30. November and the primary task in this period is to verify the information given in the tax return and its attachments.

The Oil Taxation Board decides the assessment of each company in meetings.

OTO staff divided into 3 teams responsible for a portfolio of companies and the teams consist of economists and lawyers. Two to six staff is allocated to each company and there is a rotation of team members after 3-4 years, to make OTO less vulnerable for staff turn-over but also for integrity reasons.

A thorough examination taxes place every year of the about 80 companies assessed by the OTO and extensive correspondence (100-150 letters per (major) company) by sending standardized letters made by teams of employees with special knowledge about various issues.

Tax returns vary from about ten to several hundred pages and .relatively few compulsory and standardized forms are attached. Letters of notification are sent to tax payers and an extensive report on each company prepared for the Oil Taxation Board (with the OTOs recommendation). All this audit or control work is undertaken through desk audits. Most of the reassessments done by OTO is related to transfer pricing issues.

## 3. TRANSFER PRICING ISSUES AT THE OIL TAXATION OFFICE

### 3.1. Intra –group sales of petroleum products

As mentioned before the price for crude oil is set by a Price Board and this arrangement reduces OTO's need to check the companies' sales price in relation to the arm's length principle. Still some control is necessary to ascertain that the companies use the norm price in the correct way.

For dry gas the situation is quite different for although technically speaking dry gas is a homogenous product, which should make it easier to find comparable prices, the market contracts often includes clauses that can influence the market value considerably, and assessing the economic value of these clauses is a really difficult task..

### 3.2. Intra-Group insurance companies ("captives")

It is common that oil companies chose to insure themselves through an insurance company within the group, so-called captives. The captive is often registered in a tax haven and will usually enter reinsurance contracts in the market. The issue here is firstly whether the captive has the financial strength to cover insurance claims that might occur in connection with casualties, that is whether the captive

is offering real insurance. If the answer to this question is yes, the next question is whether the price for the insurance is set at a market rate.

### 3.3. Intra-group loans

Oil companies operating on the Norwegian continental shelf can claim deductions in their taxable income according to special thin capitalization rules. This right to deduct financial costs might produce incentives for the companies to borrow from other companies within the group that are established in low-tax jurisdictions. OTO gives mainly three issues attention: 1) choice of base interest rate and maturity; 2) the margin mark-up (the difference between the interest rate paid by the company and the base rate, reflecting the company risk); 3) other costs.

A big challenge is to which degree being part of a group should influence on the interest rate setting. This group relationship can explain the size of the divergence from the market rate measured by the base rate. Typical factors that might have relevance for the interest rate are the mother company's financial strength and the how close the group affiliation is.

### 3.4. Intra-Group services ("Overhead")

The oil companies' purchases and sales of intra-group services have increased substantially the last years and now constitute significant amounts. A major reason behind this is restructuring of the companies and strong growth in the number of companies operating on the Norwegian continental shelf since 2004.

Intra-group services typically consist of administrative services such as accounting, tax, finance and IT; technical services related to geology, drilling and production, and research and development. Again two questions will be raised by OTO: 1) has the service really been delivered to the oil company; 2) if it has been delivered was it purchased at arm's length price?

If the oil company cannot provide documentation that the service was actually provided, OTO might refuse the cost as a deduction for tax purposes.

### 3.5. Desk vs. field audits

Previously OTO did many field audits with a broad scope but today only a few tax audits, maybe 2-3 per year is carried out and then on specific issues. Why has this change happened? One reason is that experienced staff in oil companies is generally cooperative, and most information can be obtained through correspondence and more informal meetings. OTO's experience is also that in most cases the quality of the accounts can be trusted:

Mainly multinational companies operate on the Norwegian continental shelf. These oil companies are obliged to undergo external audits according to company regulations in Norway. In addition they also experience partner audits, head office audits, internal audits and due to all this different audits there are good reasons for not have any suspicion of fraudulent behavior or deliberately giving incorrect information

OTO's strategy for improving compliance has been to have a highly educated and skilled that is good at working in teams on complex issues, to have good knowledge of the oil industry, technology, products and markets, and integrate competence in legal and business/economics issues

How can OTO be sure of the quality of its work? For several reasons: 1) the decisions are made by independent boards, 2) memos and technical calculations are controlled by (at least) one other employee, and 3) OTO /the Norwegian State often win lawsuits.

## 4. FUTURE CHALLENGES

In Norway's case the arrival of smaller oil companies on the Norwegian continental shelf is a challenge since some of these companies don't have the same capacity and competency in tax matters. Also new waves of company restructuring can make the future even more challenging for OTO.

## 5. CONCLUSIONS

To collect the right amount of petroleum tax is a challenging task! Extensive

Knowledge of the industry is indispensable for good results. Strong professional competencies are needed in the oil taxation unit and experience teaches us that intra-professional teams solve the cases

best. Desk audits is often more efficient and certainly cheaper than field audits but this of course depends on the climate between the tax administration and the oil companies. Mutual respect and trust are key elements in this relationship and must build over time.

*Case Study*

*Topic 3.2*

# AUDIT OF THE MINING INDUSTRY

**Stephen Wilcox**
Resource Tax Administration Specialist
(Adam Smith International)



*Presentation PPT*

## EXECUTIVE SUMMARY

The auditing of mining companies is one of the assurance mechanisms for a functioning revenue system. The nature of the mining industry and the costs associated with large projects, lead to the involvement of multinational companies, private equity, and sovereign wealth funds. These participants, by their nature, see tax as an expense to be minimized.

Revenue authorities are charged with the responsibility of upholding the compliance of participants in the tax system. The general expectation is that, where collections from the participants in the mining sector are below that which is budgeted for by the government, the issue is with the competence of the revenue authority.

The legislation is the means by which compliance will be tested, and for many revenue authorities, this limits their ability to challenge and translate revenue expectations into reality. For the legislation to be effective it needs to be robust and true to the policy intent. In the mining industry, the legislation will often contain concessions that enable mining companies to minimize their tax liability. These concessions are often included to encourage initial investment in projects, but can however, enable long-term tax sheltering for existing projects, as well as barriers to new investment.

To be able to achieve the expected tax collections from the mining industry, revenue authorities will need to have competently trained staff, with the ability to identify non-compliance. These staff will be required to understand the participants, the industry, and the opportunities for tax minimization. The identification of the risks or issues is the first part of bringing about compliance, and the primary requirement of revenue authorities is the ability to apply the legislation to the facts and circumstances presented.

The taxpayers being audited will have entered into strategic long-term relationships as part of the project development, and therefore are likely to resist interpretations that threaten the tax position they have taken, in relation to how the legislation operates. To this end, they will look to negotiate or litigate their position to achieve the outcome that is most favourable to their needs; and, being well funded, they are often able to tie the revenue authority into lengthy drawn out cases, where legislators are often unwilling to intervene until there is a legislative outcome allowing uncertainty to continue for years.

The legislation, the compliance staff, and the taxpayers will engage in a continuous interaction to deliver the expected taxation revenue from mining projects, against the perception of compliance. The need for governments to deal with gaps or loopholes that are identified by the revenue authorities in a timely process is important. Without a robust legislative framework that enables the revenue authority to ensure compliance of mining companies, they will maintain and utilize the loopholes as they are identified.

The interaction between multiple tax jurisdictions within the mining industry, where the minerals extracted from one country are transported to another jurisdiction (often through complex sale and repurchase agreements), require governments to enter into information and taxation agreements with other countries, in order to provide the revenue authority with the information and the leverage needed to maintain compliance.

Against this, the capacity for large mining corporations to build in transfer pricing arrangements, which will, on the surface, appear to be legitimate, through complex physical and fiscal transactions, will blur the ability of the revenue authority to determine actual (or ‘real’) sale prices or expenditure. Many regimes have implemented measures to restrict or limit the ability of companies to take advantage of the opportunities available to move or shield revenue from tax in a particular regime.

Thus the auditing of mining companies needs to identify and deal with the issues as they arise; identifying those issues that can be addressed through the compliance process, and those that require the framework by which the final tax liability is assessed, to be changed.

## 1. INTRODUCTION

The development of an appropriate compliance strategy for the effective administration of the mining industry is dependent on the appropriate training and qualification of the revenue authority's staff, in combination with a legislative framework designed to support the administrator in ensuring compliance. The varied nature of taxpayers involved in mining operations provides challenges to the government and the administrator in ensuring that taxpayers are treated fairly and the revenue expected is collected.

### Building Compliance Capability and Developing Robust Legislation

For any audit strategy to be successful, it must address the need for:

- Suitably qualified staff;
- Risk and intelligence capacity;
- Effective work practices and administration;
- Technical advisors to deal with complex or specialised matters; and
- Appropriately developed and robust legislation

For the revenue authority, the pool of available resources will be limited by capacity for remuneration and the perception of the agency, by potential staff. For government departments, this means that the ability to up-skill and develop the capability of the audit teams is paramount to the success of the audit program.

For many agencies, effort has gone into the creation of training material for the compliance areas, as well as the implementation of common work practices designed to improve on the efficiency of audit programs. To build effectiveness however, there is a need to develop the capability of the audit staff to focus on specific issues relating to the industry. For the mining industry, there are a number of unique risks associated with the undertaking of compliance action, and these will be discussed throughout the paper.

Legislation

The robustness of the legislative framework will be the ultimate determinate of the success of any audit program; and any gaps in legislation, lack of clarity, or arbitrage opportunities, will encourage participants to reduce some or all of their liability for taxation. Where the legislation provides incentives or concessions for expenditure of a particular type or nature, taxpayers will attempt to ensure that they can qualify for the benefit.

For the auditing of the mining industry to be effective, the legislation needs to be structured to deliver clarity as to the intent of the specific provisions. In particular, where the legislation provides incentives or concessions, the law should appear transparent as to what is being provided for in the provision. As the mining industry is diverse, and ranges from artisanal miners to complex large multinational companies with diverse structures and arrangements, provisions can create unintended consequences. Furthermore, the law also needs to be clear in order to minimise the scope for misinterpretation and to enable the administrators to operate effectively in their program of work; while the stability of the law is also of great importance, as the perception of risk associated with ever-changing legislative provisions can make it difficult for both the administrator and taxpayer to comply.

For governments, the use of a design approach in the development of legislation is important in ensuring that the legislative outcome achieves the objectives of the policy.

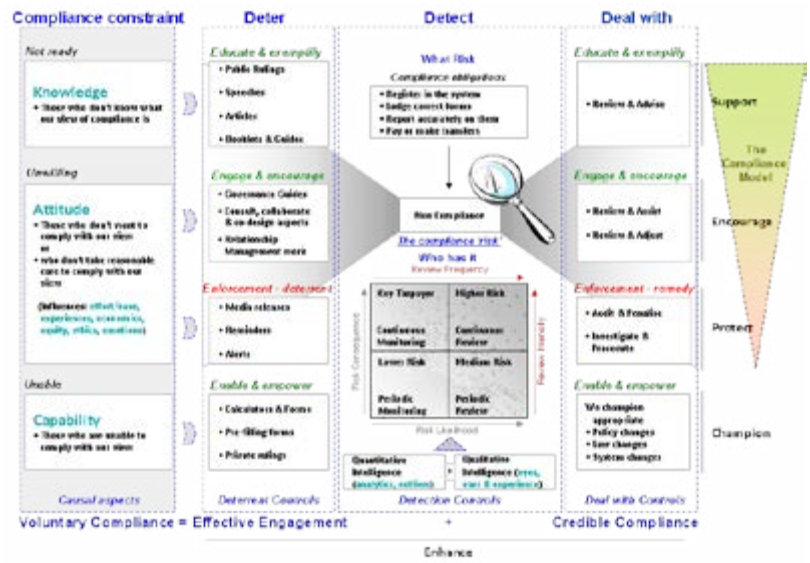
To that end, the engagement of the administrators in the development of the law effectively ensures that the policy's intent can be clearly delivered throughout the process, and that there is scope for effective administration. Oftentimes, legislation is drafted in isolation from those whom it ultimately affects, which can lead to policy intent being lost, or failure of the legislation to deliver the desired outcome.

## 2. DEVELOPING THE STRATEGY FOR MINING INDUSTRY COMPLIANCE

Before the examination of risks can commence, the revenue authority will need to develop a strategy for:

- Information Collection;
- Risk Assessment; and
- The Development of Compliance Products

**Risk bow-tie for regulatory compliance strategies1**




The use of a methodology like that of the bow tie can enhance the revenue authorities capacity to undertake effective deterrence activities against those taxpayers representing the highest risk. The diagram outlines the opportunities available in the development of an integrated strategy for compliance. When applied to a particular industry or sector, more detail can be included that is specific to the population in focus.

In the application of this process to the mining sector, the specific nature of the industry and its compliance risks can be articulated; and strategies to effectively deter, detect, and deal with, can be implemented.

1 *Description* *Risk bow-tie for regulatory compliance strategies - deter, detect & deal with*
*Date* *18 August 2011*
*Author* *Stuart G Hamilton*
*http://upload.wikimedia.org/wikipedia/commons/8/85/Regulatory_Compliance_Risk_Bow-Tie.png*

Information Collection

The information collection and management strategy for the auditing of mining companies should enable the determination of the higher risk companies; and ideally, should be integrated into the government's holistic approach to managing mining companies, to ensure that there is sufficient entrainment between each agency's collection processes, with a view to facilitating seamless integration between each phase of information collection, aggregation, and analysis; eventually enabling thorough crosschecking and analysis of the information provided.

Government agencies will generally collect information from mining companies, through various agencies, and for differing purposes. Alignment of the information collection processes across agencies will provide the revenue authority with significant checkpoints regarding tax return information, effectively enabling comparison against other information provided to other agencies.

Some examples of government data which could prove useful in strategy development include:

- Capital inflows/outflows information through Central Bank or declarations
- Mining lease details from mining authority; including changes, expansion, and combinations
- Exploration and mining reports from the mining authority
- Environmental studies and reports from environmental agencies
- Customs information pertaining to the arrival, and value of machinery entering the country
- Mine development reports, including the proposed expenditure from the mining authority
- Export licence and activity reports from Customs
- Customs information pertaining to the transfer of minerals out of the country
- Production reports and cash flow reports from the mining authority
- Transaction reporting from banking reports
- Immigration records for travel of employees (eg. 'fly in' and 'fly out')
- Other reports, proposals, etc. provided to government agencies

The specific information collection from mining companies, as part of the compliance strategy, should focus on risk, and should be supported by effective data analysis techniques. The tax return for mining companies should include all information requested of other companies, as well as specific questions designed to enable the ongoing monitoring and tracking of risk; either in the return, or via separate schedules.

Where possible, the return form information should enable the revenue authority to undertake risk assessment and ratio analysis, and complete comparative analysis between entities involved in similar businesses.

**Risk Assessment**

Risk assessment of taxpayers against a predefined set of parameters will enable the revenue authority to examine the information provided by companies, in accordance with risk filters, other agency data, third party data, taxpayer public information, and other companies in the same industry.

The development of effective risk filters is dependent on the revenue authority capturing enough information each year, and supplementing this with the outcomes from compliance activities. These filters need to be tested and adapted each year to ensure their effectiveness against changes in the industry and participants.

**Development of Compliance Products**

The development of a suite of compliance products will assist the revenue authority in efficiently deploying its available resources to the areas of the greatest risk; and each product should effectively target the risks identified for taxpayers. Using a single product type against all taxpayers is likely to deliver inefficient outcomes; thus, the intensity of the compliance interaction should be assessed against the relative risk that each taxpayer represents, as the time and effort involved in the activity needs to match the risk of non-compliance by the taxpayer.

Generally, compliance products would cover areas including education and advice; risk reviews; audit products; and compliance and Advanced-Pricing agreements; each of which would give the revenue authority the capacity to expend its resources, based on the risks identified; as well as the ability to leverage the outcomes of the compliance work against other taxpayers in similar situations.

## 3. EDUCATION AND ADVICE

The revenue authority's provision of education and advice services will ensure that taxpayers are able to meet their obligations where they want to. These products should be tailored to the specific needs of a taxpayer (or groups of taxpayers), and should cover: instructions on how to register, lodge, and complete return forms; and explanations of specific areas of law, which provide the revenue authority's view on the law (including what the revenue authority would consider as acceptable

treatment of particular transactions). By providing taxpayers with this information, the revenue authority is enabling taxpayers to interact with confidence, as to the likely treatment of transactions and business arrangements.

Furthermore, the advice products can assist in the training of staff, by identifying areas of the law that are contentious; and should advise individual taxpayers on the compliance treatment of a transaction, but should generally be limited to actual transactions, rather than hypothetical transactions.

**Risk Reviews**

A risk review is a relatively inexpensive compliance product that can be delivered without leaving the office; the undertaking of which provides scope to identify and quantify the areas of concern, without expending significant time or resources; thus allowing for more taxpayers to be reviewed and trends to be more accurately identified.

The complexity of the risk review product should be adapted to the type of taxpayer being reviewed. The review product can be increased in complexity to match the nature and type of review being undertaken. For the more complex taxpayer reviews these should be undertaken including client visits.

**Audit Products**

Complex audit products would tend to examine all the taxpayers' affairs for all tax types; and would be used where the consequences are significant, and the taxpayers' past behaviour would indicate a likelihood of their involvement in tax planning arrangements. A complex audit on the main high consequence taxpayers would also be regularly undertaken with a view to ensuring the maintenance of compliant behaviour.

Specific tax-type audits and reviews focus on particular tax types (e.g. employment taxes or VAT/GST), enabling the revenue authority to focus resources and develop capability around these taxes, to ensure that compliance is maintained. Having teams focused on particular risks, issues, or taxes is an excellent way to build capacity within the revenue authority, although caution should be exercised to ensure that this approach does not create specialist areas that are not integrated in the wider work of the revenue authority.

**Compliance Agreements**

In the case of taxpayers requiring certainty as to their taxation affairs, the revenue authority can enter into compliance agreements, which tend to impose a mutual obligation on the taxpayer and the revenue authority, with the purpose of providing the taxpayer with confidence in relation to the tax position of their tax affairs, and certainty to transactions in real time. The obligation on the taxpayer in such agreements is to disclose to the revenue authority, all significant transactions and changes in operation, so as to ensure they can be assessed in relation to the tax treatment.

The principal behind this type of compliance product is to have all the taxpayer's legacy compliance issues dealt with, whilst ensuring that future compliance activity would be minimal, by maintaining the revenue authority's engagement throughout the year. However, due to the intensive and intrusive nature of such compliance products, they would generally only be offered to significant taxpayers who are committed to high levels of compliance.

## 4. ADVANCE-PRICING AGREEMENTS

Advance Pricing Agreements (APA's) are agreements often used by revenue authorities to provide certainty around the particular treatment of transfer pricing arrangements; the purpose of which is to set a framework whereby, if the taxpayer maintains a particular business practice, the revenue authority will agree to a specific margin or mark-up.

These agreements generally last for a limited period (3-5 years); have review mechanisms built into them; and, when implemented by agencies, can often be leveraged to bring consistency to the whole sector, by establishing an acceptable benchmark that reduces compliance activity, whilst guaranteeing revenue payments from the taxpayers involved.

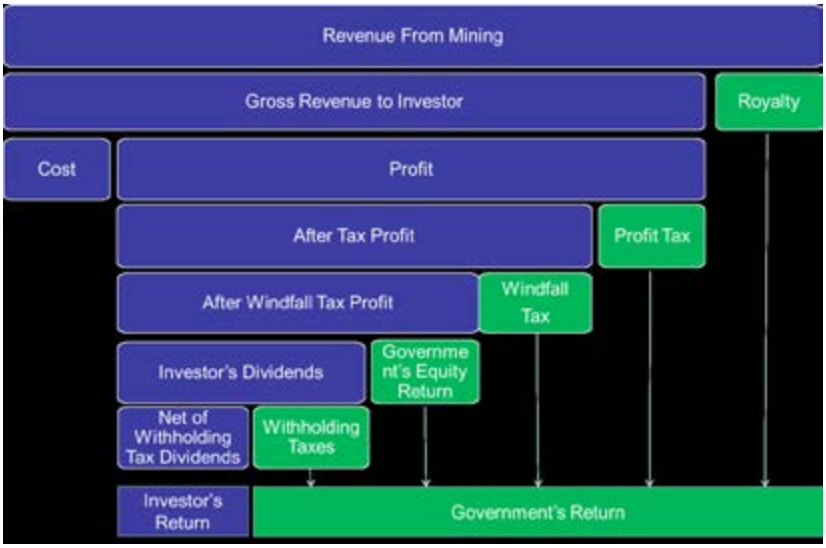
Outcomes from Taxpayer Audits, Objection, Appeals, and Court Cases

With any compliance program, the final outcomes from compliance actions need to be integrated into future action; and where the revenue authority has completed a case, whether the decision is upheld or overturned, the learning from the cases should be integrated into the existing information gathering, risk assessment, and compliance products. Embedding the learning through effective debriefing, communities of practice, and audit guidance notes will all lead to capability development for the compliance area.

**Specific Compliance Areas to be examined in the Mining Industry**

In the mining industry, governments collect taxation through the deployment of an effective fiscal regime, where each level of taxation has its own area of focus and its own compliance risks. For revenue authorities, the ability to ensure that, at each level, the correct taxation treatment is applied is critical for the next layer to function as intended.

## 5. MINING INDUSTRY TAXATION POINTS




- Royalties
- Income taxation
- Resource rent taxation
- Government proportional ownership
- Withholding taxes on dividend, interest and other types of payments
- Employee taxation, social security, health, superannuation
- Goods and services or Value Add Taxation
- Customs duties, levies, fees and charges

**Areas of Focus for Mining Industry Audits**

Having the appropriate information, risk assessment, and compliance products leads to the undertaking of the audits. The nature of the mining industry is such that it operates in a high-risk/high-reward environment, up to the commencement of operations.

Thereafter, much of the operation of a mine, up until its closing, resembles the operational management of many other businesses.

That is not to say that the opportunity of tax minimization does not continue to exist throughout a mining company's operations; but rather, it is simply the recognition of where there are unique operational risks, and those of a more generic taxation compliance nature.

**The basic calculation of mining profit**

| Item | ($m) | Practical Issues | Possible approaches for treatment |
|---|---|---|---|
| Revenue | +1000 | Transfer Pricing<br>Hedging | OECD Guidelines<br>Advanced Pricing Agreements<br>Check (or Posted Prices)<br>Treat separate from Mining Income |
| Operating Costs | -200 | Transfer Pricing | Same issues as above. |
| Interest Expense and Loans | -150 | Transfer Pricing<br>Thin Capitalisation | Same issues as above.<br>Debt to Asset Ratio |
| Exploration | -100 | Amortization Rules | Definition and amortisation |
| Development Expenses | -200 | Amortisation Rules | Definition and amortisation |
| Capital Allowances | -125 | Amortisation Rules | Definition and amortisation |
| Other Expenses | -50 | Transfer Pricing | Set limitations for head office charges<br>Apportionment rules<br>Same issues as the revenue section |
| Taxable Income Before Loss Carry Forward | 175 | | |
| *less* Loss Carry Forward | 75 | Duration | Definition and amortisation |
| Taxable Income | 100 | | |

| Issue | Possible Approaches |
|---|---|
| Ring Fencing | Require investment in each project to be via a special purpose entity<br>Require segregation of properties and separate accounting by project |
| Incentives - including accelerated depreciation, tax holidays, and investment credits | Limit to the extent possible |

## 6. EXPLORATION AND MINE DEVELOPMENT COSTS

In the mining industry, resources tend to be located in remote areas, and are subsequently difficult to locate and extract. Thus, most tax regimes provide incentives to both search for resources, and develop them; and therefore, dependent on the law, issues invariably arise around the definition of what expenses are eligible for deduction for each phase of the operation. For governments, the policy objective is generally to facilitate the extraction of the resource, and collect a portion of the revenue associated with this. Thus, the concessions provided to encourage resource location and development are often quite generous, when compared to similar types of transactions for other operations.

Where there is a trend for preferential treatment of exploration and/or mine development costs, miners will look for the opportunity to arbitrage expenses into these categories.

The types of concessions granted include the following:

- Immediate deductibility against other mining or general income
- Indefinite quarantining of losses associated with a particular phase(s)
- Uplifting or augmenting of eligible expenditure to offset future profits
- Transferability of expenditure to related parties; or maintenance of expenditure attributes in ownership changes
- Ring fencing; rules to govern the usage of the expenditure

From a compliance perspective the key focus areas become:

- Definition of the project
- Expenditure that is eligible for each phase and its treatment.
- Whether indirect expenditure is eligible; and if so, how it is to be calculated

- Treatment of expenditure that is undertaken in an earlier phase being reclaimed again at later phase
- Augmentation only being applied to eligible expenditure
- Quarantining and transferring of this expenditure

For each phase, there is a need for the compliance team to be able to successfully navigate the treatments available, and ensure that the miner only gains deductions for expenditure that is eligible. It is not necessary to vouch each and every receipt, although examination of the accounting treatments and appropriate evidence of the expenditure itself is required.

A common issue with expenditure, related to this phase of the project, is that capital assets end up being recycled into deductions once the mine becomes operational. This includes situations in which the asset is initially allowed an immediate write off; and where the legislation allows for transfer of expenditure to other projects, there is an incentive to classify this expenditure to meet the transfer requirements.

As the definition of exploration is often linked to definitions in other legislation, issues can arise where there are changes over time, or amendments to these definitions or phases, without recognition of the link to taxation revenues. Of particular concern for expenditure in this area, is that the periods of review available to the revenue authority are often limited. As the phases prior to production can take years (even decades), there exists a definite risk that the expenditure will pass unreviewed, as the companies involved will not be earning income or paying tax; and therefore, compliance risk filters need to ensure that miners with expenditure in this category are reviewed before the periods of review expire.

Changes in Ownership, Restructuring, and Mine Acquisition Costs

Mining projects are highly likely to undergo changes in ownership over their life, with the entity or structure that ultimately brings a mine into production often being separate from entity that initially undertook the exploration; and even in cases where this entity remains constant, the ownership of the project will likely have acquired joint venture partners, through various types of arrangements.

In some cases, where the taxpayer (in-country leaseholder) has not changed, these changes take place offshore, and often do so in tax havens, where there is little transparency to the revenue authority; subsequently limiting the ability of the government's mining agency or revenue authority to determine the ultimate ownership of projects, and

therefore leading to a reduction in potential capital gains tax revenue, as a result of the changes not happening 'in-country'.

**Ownership Changes and Restructuring**

With the prevalence of changes in ownership throughout the life of mine there are opportunities for taxpayers to plan their strategies to take advantage of legislative concessions. This, along with mining projects being run as joint venture operations with many partners entering and exiting, means that the revenue authority will find the tracking of ownership and the changes in ownership an important part of the compliance program. With the restructuring of projects comes the ability to inject new capital or debt into a project and have the funds applied to other activities, ensuring that the project's overall tax position does not change overtime. Depending on the legislation in the country, the changes in ownership may also be undertaken in ways that limit or avoid capital gains tax.

**Farm-In and Farm-Out Arrangements**

The costs associated with the development of mining operations means that taxpayers will enter into arrangements to bring in other partners to be part of the project. These arrangements are often undertaken using a farm-in process, whereby one party gains an equity interest in the project, through the expenditure of a fixed or floating amount of capital. The nature and structure of the investment in the project can blur the lines between deductible expenditure and equity interest; and the entitlement to deductions can also be difficult to determine, as the project changes over time and potentially other taxpayers join the project.

For the revenue authority, it is important to have the ability to look through the transaction and determine how the transaction has been structured. If the transaction includes a combination of specified investment for the equity interest, then the expenditure would need to have been incurred for the deduction to be allowable. In some cases, the use of a farm-in arrangement can defeat capital gains tax provisions, as the changes in percentage ownership do not trigger the disposal definitions in the legislation.

**Revenue Amounts and Revenue Recognition**

The determination of the revenue amount (or taxable sale price) is often the focus of compliance activities, as the final sale price is often outside of the borders of the country, and difficult to verify or tax; and in most

cases, value for the sale price is determined through a reduction in the sale price, to reflect expenditure incurred beyond the taxing boundaries of the country. Many royalty regimes include a calculation for adjusting the sale price to take into account the costs of sales and transport; while in the case of income and rent taxes, often in lower tax countries, the development of sales and marketing hubs can create the opportunity to move the profit from onshore to the tax preferred country.

When the sale occurs after the mineral has passed the taxing point, the timing of revenue recognition can also become an issue, due to a timing difference and a deferral of tax, where there are significant time differences between the movement of minerals and the recognition of the revenue.

**Transfer Pricing Arrangements**

It is not proposed to focus on transfer pricing in this paper; suffice to say that transfer pricing opportunities exist throughout the mining process as a result of the size of the companies involved, and the mining projects themselves. Most governments have adopted the OECD guidelines on determining a fair price for the purposes of taxation administration.

As can be seen in the details that follow, in the mining industry, vertical integration and related party transactions are common. The effective treatment of these transactions requires the revenue authority to have the capacity to challenge abusive arrangements, and to apply a fair regime to taxpayers. Legislation enabling taxpayers to determine methodologies are often challenged, leading to lengthy court cases where the outcome is uncertain due to the nature and complexity of the methodologies.

**Sales and Marketing Arrangements**

Sales and marketing arrangements of mining companies have been added to the already large number of opportunities for the mining industry to use transfer pricing, in order to move revenue away from the country of origin. Taxpayers have been creating profit centres to undertake the sales and marketing of all their resources, arguing that this achieves the highest price for their commodity.

Some of the issues associated with these centres is that they make their profit on a percentage of the sale price, which is significantly in excess compared to the value added, or the risk born, by the sales and marketing centre.

In order to minimize the ability of taxpayers to apply this methodology, some countries have introduced a prescribed deduction for this activity, particularly for royalties and resource rent taxes. An alternative to this is to set the sale price of the mineral, based on the value traded on the day the mineral leaves the country. While both these methods produce a more certain outcome, they do not provide equity across taxpayers, and can enable taxpayers to get larger deductions than they would otherwise have been entitled to.

**Expenditure**

Expenditure on mining projects is often well controlled through the presence of on-site accountants, local accounting firms, and services provided by global accounting firms; and therefore, rarely do issues arise relating to whether expenditure has actually been incurred. Rather, the issue is usually in identifying the applicable mining project, and determining whether or not it is being treated correctly.

As mining projects develop, so too do the accounting sophistication and record keeping processes, as the changes in ownership and structure can often require the movement to new accounting systems, without the loss of history and detail.

For compliance activity, designed to facilitate a project's ability to trace transactions over time, it is important to ensure that deductions are claimed only once per project; particularly where there are loss history rules allowing for losses to accumulate over time.

In the case of large mining companies, consisting of multiple operations in a single country, the apportionment of expenditure to the correct project is of paramount importance; and where there is also ring fencing provisions, allocation will also be required upstream and downstream from the project boundary. If there are different tax rates applicable to mining activities, as opposed to other business operations, the ability to ensure that expenditure is allocated correctly is also important. For the revenue authority, there is a need to have advice in the public domain to ensure that taxpayers have a clear indication of the authority's interpretation of the provision.

**Capital Expenditure, Depreciation, and Lease Back**

As mining is a capital-intensive practice, governments generally provide incentives to mining companies, usually by way of immediate deductibility or accelerated write-off.

This creates issues with the definition of what is a mining asset, and the treatment of those assets where there is a change of use. The definition of the mining asset is often associated with the use of the asset, which can change over time, and enable tax planning around how assets are treated at the end of their useful life. For example, where a company constructs roads that are later transferred to the State, a question can arise as to the appropriate treatment of the asset. The treatment of vehicles that are used both on-site and off-site, can also allow companies to avoid customs duties and gain deductions for vehicles that are not used in mining.

The pooling of assets is often allowed in order to reduce the compliance burden, and this creation of pools can also reduce the transparency related to the assets; particularly where companies use assets on multiple sites. For example, if a drill rig is used on multiple tenements, questions can arise as to which tenement owns the asset and who is entitled to the depreciation, as well as the appropriate income amounts to be returned.

Sale and reset of asset price can enable assets to move income to non-mining businesses and reduce resource rents, as the expenditure on leasing the asset would reduce the profit for income and resource rent taxes.

Particular issues relating to the treatment of mine improvements are whether the expenditure is revenue or capital in nature. The determination of what mine improvement can or should be capitalized rather than allow the immediate deductibility of a mine expense. As each country has its own rules around the treatment of expenditure there is always the risk that taxpayers will claim an immediate deduction.

**Rehabilitation Costs**

An integral part of mining operations is the point of the exhaustion of the resource, the realization of which, for most countries, usually requires some form of ‘make good’ to be undertaken. Included in this process are often tax concessions relating to the refund of previously paid taxes; or the allowance for a deduction, for funds that have been set aside to meet the future liability.

## 7. INSURANCE

Insurance payments would normally be a deduction for global mining companies, as they often have insurance policies at a corporate level and, at the very least, charge this expenditure to projects on a full cost recovery basis. For income tax, it is reasonable to allow a deduction for the expenditure where it is actually paid; and there can be shown to be policies in existence, which often cover non-mining related activities, including head office and directors liabilities. The allocation of the policy costs requires the compliance officer to determine the nexus between the expenditure and the mining project.

One area of concern for the revenue authority is where the insurance is subject to captive insurance provisions. Here, the identification of actual deductible expenditure and the offsetting of risk that is being applied, may not match the commercial reality of arms-length transactions. The growing use of captive insurance vehicles by large corporations make the determination of relevance of payments to the provision of insurance difficult.

In the case of resource rent taxes and ring fencing, the appropriate apportionment of insurance and other expenditure is important in order to limit the deduction to only what is reasonably attributable to the mining project. However, where the insurance policy is based on the global risk profile of the company, the apportionment methodology needs to ensure that mining projects are not disproportionately being charged the expense. Furthermore, the recognition of incomes associated with claims on the policy, which relate to the project; need to be returned by the project.

With insurance, the policy may need to be invoked, and where this happens at the head office of the corporation, there may be no recognition in the accounts of the business operation of the entity for which the event occurred; such as a circumstance where the captive insurance is implemented through a self-insurance arrangement, whereby there is no payment to the company. The identification of claims and payments may be seen in the joint venture partners' accounts, where they have received payments from the project operator for lost production; and there can also be cases where some joint venture partners do not make claims against their insurance, and return no income from the payment

**Research and Development**

Research and development is often afforded concessional tax treatments, making it an area for companies to classify particular expenses as R&D. Many global companies will charge all their associated entities a fee, which is used in the creation of pools for R&D expenditure (Mutualized Research Costs), and can be used in any jurisdiction, but do not guarantee that the entity would be excluded from paying a fee for the use of the created technology or mining method.

For governments, there is a desire for companies to develop and innovate in order to reduce their costs, and thereby increase their profitability. Often however, these arrangements can lead to companies further minimizing their profits, through R&D expenditure that brings no such increase in profitability.

## 8. PAYMENTS FOR THE USE OF TECHNOLOGY OR INTELLECTUAL PROPERTY

The payment of private royalties for resources or land use, technology, and intellectual property, requires the compliance officer to be able to differentiate the payments in order to determine if they should be allowed for the mining project. Where the landholder is entitled to receive a royalty or like payment for loss of use of their property, a deduction is generally allowed for the purposes of income tax, but not for royalty taxes; and the treatment of these payments in the context of resource rent tax will depend on the design of the legislation.

Where this payment is made by way of an in-kind provision of goods and services, there can be issues as to the actual value to be allowed as a deduction. For example, the building of a school, village, or shopping centre can create assets of more value than was expended. Further, where a related party completes the undertaking, it can be difficult to determine the allowable deduction.

Payments for the use of technology or the rights associated with improved productivity methods (e.g. patents) can be claimed by companies, and for the revenue authority, it is difficult to challenge or deny these. Often these payments are made to another company in the global group, being a real expense for a taxpaying entity, and are difficult to deny or adjust.

## 9. LABOUR COSTS

Generally, labour costs are deductible in relation to the projects, and the determination of what employment taxes should apply to 'fly-in-fly-out' staff and contractors can often be difficult to determine and apply consistently. As mines or fields are often geographically distant from major cities, living-away-from-home, travelling allowances, and other fringe benefits will form the basis of salary packages, and the tax treatment of these allowances can be complicated by the residency and status of the individual worker.

Employers generally include significant benefits in the employment packages of key staff, which can sometimes require withholding of taxation, where the benefit exceeds thresholds or gives bonuses linked to performance outcomes. Additionally, many regimes also include requirements for health levies, social security, and retirement savings, to be deducted from wages and to be remitted; and with the diverse range of employees working at a site, companies must be prudent to avoid making mistakes as to the status of the employee. To that end, as part of the compliance plan, an examination of staff payments and the support provided to the staff should be undertaken.

Take-or-Pay Arrangements with Suppliers and Service Providers

In the mining sector the interaction between the business of mining and the extraction, beneficiation, transport, and sale will often include third parties; and in many of these arrangements contracts carry 'take-or-pay' clauses, whereby the company must pay for the services provided, whether or not they are able to deliver the material.

For mining companies, the use of take-or-pay arrangements are common when dealing with third party infrastructure providers, contract miners, or mineral processors. In these cases, it could be argued that the discount for certainty of service should allow deductions for periods of non-supply of minerals. In the case of take-or-pay arrangements where the service is provided by the project operator, a joint venture partner or related party there can be issues as to the reasonableness of the claimed deduction.

The treatment of these types of arrangements needs to be considered in light of tax that is being applied. The treatment in royalty and resource rent taxes may be different to that applied to income tax, as it is more appropriate that these payments be allowed in full for income tax, than perhaps royalty or rent taxes. For the revenue authority, the ability to be able to limit deductions where there has not been a mining

activity would only be possible if the legislation specifically limits or precludes the deduction.

**Project Funding**

Mining projects require significant capital investment, and the way in which the money is invested can provide significant tax advantages for both the company and the investor.

Where the transactions involve complex financial instruments crossing many borders, it is more likely that there are tax drivers for the structuring.

## 10. DEBT FUNDING ARRANGEMENTS

How a company funds its operations is often dependent on the investment cycle and expected returns in the market place. The complexity of arrangements available to businesses is only limited by the creativity of the financial services sector. It is important to note that these arrangements will generally involve large sums of money, on which investors will expect to gain significant return; generally higher than those which would be offered as interest on bank deposits.

With the long project lifetimes and high capital nature of the mining sector, investors and lenders look to ensure that there is security over the funding of projects, and protection of the capital that they have invested. For revenue authorities, the challenge is in determining if the funding is in fact debt funding, or rather falls into the category of equity investment.

**Debt Vs. Equity**

The distinction between debt and equity for the financing of projects will depend on the legislative framework of the country involved, and is particularly complex in relation to unpicking transactions in order to determine the appropriate tax treatment of the investment; a matter which can be further complicated in instances where the same instrument is treated differently in different countries or regions. For the active mining entity, there is an incentive to ensure as much of the funding as possible is counted as debt, up to the point of the thin capitalization limits. From a revenue administrator perspective, the information provided on an annual basis will highlight where there is a move from equity to debt, and risk filters should be used to identify these companies for more thorough compliance treatments.

Some of the types of investments that can cause issues are those where:

- An investor takes a royalty over the mineral deposit in lieu of payment of regular interest payments
- An investor buys an interest in the company and agrees to purchase a fixed amount of the resource, either at a fixed or floating price
- An investor agrees to sell their share of the ore at the mine gate, and to buy back a beneficiated product at a later stage

In each of these cases, it will be up to the revenue authority to determine the nature of the investment, in line with the legislative provisions relating to the investment.

**Interest Charges**

Due to the complex nature of the financing of a mining project, it can be difficult to determine whether the interest claimed relates to a loan through ordinary means or a related company transaction, and it is important to establish which interest charges can be claimed as a deduction against the income taxes of the business. The interest rate charged to the domestic country can often be linked to the cost of debt for the country (e.g. LBTR +200bp), and in these cases, the interest charge is likely to be much higher than the actual interest rate, which the economic group would be able to raise in the market.

Various compliance techniques can be applied to identify the source of funds and the nature of the loans; however, if there is no legislative support to limit the interest deduction claimable by the entity, then the contracted amounts will be claimed. Here again, the revenue authorities power to limit deductions is derived from the legislative framework. The ability for global companies to price domestic companies out of the market flows from their ability to use capital raised at rates significantly below that available to the domestic entities.

**Thin Capitalization**

Where a country applies a test for thin capitalization, it is important that the tax return information collects the required details at the time of lodgment, thus enabling the revenue authority to test the treatments at the time of lodgment, and undertake targeted reviews of taxpayers, based on their responses.

There would still be a requirement in regular compliance activity to ensure that this is tested where there are significant debt deductions

made by the company. A complicating factor can arise in these situations, where the funding is at the economic group level, and the company needs to allocate this funding to particular projects. This can occur where the ring fencing provisions create individual sub-entities, and in these cases the legislature needs to determine at what level the test should be applied. For the revenue authority, the further the test is adjusted away from the actual transaction, the more difficult it becomes to determine the eligible expenditure.

**Hedging and Derivatives**

The treatment of hedging and derivatives is often an area of contention in the taxation of mining companies; especially where the company is able to de-risk its operations through the use of a hedging contract or derivative, and the tax treatment of the gains or losses becomes the area of greatest contention.

The treatment will vary depending on which tax type is applied and what other rules are in place for the projects. Often the treatment for royalties is different to that of income tax and resource rent taxes, and will require the company to ensure that its accounts allow for the unpacking of these arrangements, to determine the correct revenue for each tax. Where these financial instruments are used, the compliance staff will be required to examine both the actual transactions, and the effect the product has on the tax payable for the business.

For the legislature, there needs to be clarity over the taxation arrangement that is being taxed. The collection of revenue is it from royalty, rent tax or income tax needs to have its own rules as to the treatment of gains and losses from the use of financial products, including hedges and derivatives.

**Ring Fencing**

Ring fences are common in the legislation covering the mining industry, and are used to define the mining project, as well as limit the amount of non-mining expenditure that can be applied to the taxable project. Resource rent taxes use ring fence provisions to reduce the offsetting of expenditure from one project to another, and it is invariably the case, that the design and definition of the ring fence will have a direct effect on the liability of projects.

**Definition of the Ring Fence**

The definition of the ring fence in a mining project is usually associated with the mining lease boundaries of the project, and while this does provide a degree of certainty, as mining project boundaries often change over time, the effect these have on enabling the entity to bring deductions into a project can be profound. One of the other issues associated with the definition of the ring fence is the creation of the upstream and downstream taxpayer; as, depending on the rates of tax and the treatment of deductions, it is possible for taxpayers to arbitrage based on the boundary created by the ring fence.

**Determination of Revenue Amounts**

With the creation of a ring fence, one of the issues is that the final sale does not occur at the ring fence boundary, which often means that companies need to determine the sale price at the boundary, based on either a statutory formulae or via a net back calculation. Both methods create an arbitrary basis for the calculation, and revenue authorities need to undertake extensive compliance activity in this area in order to determine if the revenue and the methodology are being applied correctly.

The nature of the calculation methodology will need to change as processes and technology changes, as it is often the case that legislation does not keep up with changes in business practices. The discrepancy between the actual sale price and the revenue amount calculated at the ring fence can be the cause of protracted disputes between the miner and the administrator.

**Allowable Expenditure**

The calculation of allowable expenditure, like revenue, will include the quarantining of deductions from outside the ring fence. The allocation of expenditure to either upstream or downstream makes the calculation of the allowable amount subjective. The need to apportion expenditure between up and down stream also makes it difficult for companies to report accurately and consistently, as labour and machinery often perform tasks on both sides of the ring fence.

**Legislative Change**

While legislative change is part of the good governance, governments can often find that the industry will be vocal as to the amount and types of changes that are being implemented. Governments will often

choose to reduce the complaints by introducing new legislation, with grandfathering clauses to maintain the rules for existing taxpayers, which has the effect of expanding the legislation and forcing the administrator to deal with multiple rule sets for taxpayers.

Concessions granted in legislation, even those with sunset clauses, create a distinction between existing and new activities, and taxpayers will look to expand existing projects in an attempt to keep them inside the existing concession, while new projects that are excluded from the concession will look for ways to bring these projects within the bounds of the concession through combining projects.

## 11. CONCLUSION

It can be seen from the above the auditing of mining companies requires the combination of a strong revenue administrator and robust legislation. Each have a role to play in the ensuring of compliance of the mining companies. For the administrator the ability to develop and maintain staff, requires the capability to undertake effective capacity building. The capacity building requires more than auditing skills and training, the implementation of an integrated strategy to develop and enhance the knowledge of the staff is needed. There is the opportunity to use the knowledge gained from compliance cases and the use of external service providers to deliver specific improvements, will enhance the productivity of the compliance staff and embedding of learning in the organization.

In order for the development of robust legislation governments need to be willing to tackle difficult issues and risk alienating a sector of the economy, so that the whole of the economy benefits from the profits in the mining sector. Through the use of integrated design methodology in the preparation and implementation of legislation, governments will ensure that the taxpayers and the community understand the benefits and costs of particular policy choices. It is through this integrated approach that legislation will deliver on its objectives and the taxpayers and the community will have been engaged in the design of the system. Transparency in development of the legislation and the collection of revenue will further highlight the success or otherwise of the legislation, and afford government the opportunity to adjust the policy should it be found not to be delivering the desired outcome.

For governments and revenue authorities that are looking for support in these areas Adam Smith International has a range of experienced consultants who can assist you in meeting your goals and enhance the delivery of your outcomes.

| ASI's extractive industry services cover seven areas of support: | | |
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| Strategy & Legislation | Revenue Growth | Technical Services |
| Institutional Reform | Capacity and Communications | Transparency & Governance |
| | Economic Infrastructure Development | |

*Case Study*

*Topic 3.2*

# AUDIT OF THE MINING INDUSTRY

**Alejandro Burr**
Director
Internal Revenue Service
(Chile)

***Contents:*** *1. Introduction. 2. The importance of mining in Chile. 3. Mining taxation in Chile. 4. Mining control within the institutional context in Chile. 5. Tax audit to mining in Chile.*

## 1. INTRODUCTION

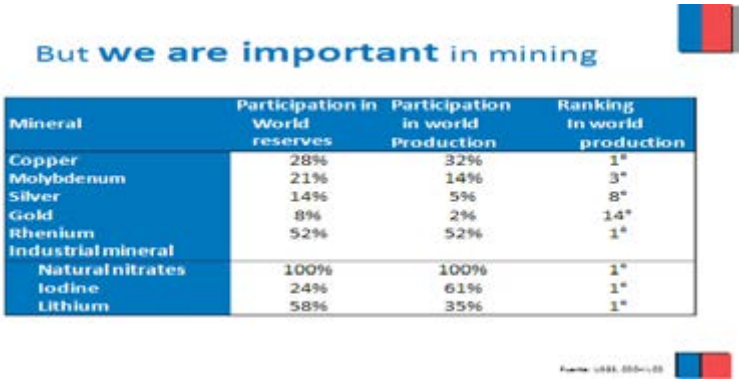
Tax administration faces important challenges for controlling large mining companies due to the complexity of this industry. This sector has multiple transactional and operational variables that need to be known for an effective control. Besides considering the specific tax aspects applied in each country and the treatment of transnational operations and transfer pricing, we also need to know the regulations in force (exploration and operation permits, mining security, mineral trade); customs (content and amount of mineral exported); labor and environmental regulations (mines closures), since they affect taxation.

The Internal Tax Service (SII) experience is built based on a constant activity over the years, because (as previously mentioned) Chile is a country where mining justifies an important part of the GDP, exports, and tax revenue. In this context, the SII has taken strategic decisions about the control of large mining companies, and has made great efforts to provide officers with adequate training and a methodological and institutional framework allowing them to successfully manage their control task.

This document presents general issues and is structured as follows: Section 3 shows a synoptic vision about why mining is important in Chile. Section 4 summarizes essential aspects of mining taxation in the country. Next, section 5 describes the main tax institutions responsible for regulating and controlling the mining activity. Finally, section 6 describes the tax audit in the mining industry.

## 2. THE IMPORTANCE OF MINING IN CHILE

Chile has a population and a territory equivalent to 0.2% of the world and its GDP is 0.3% of world's GDP. According to these dimensions Chile is not very important. However, regarding mining activity, our country is a major player among the first for reserves and production share (see Table 1) [1].




| Mineral | Participation in World reserves | Participation in world Production | Ranking In world production |
|---|---|---|---|
| Copper | 28% | 32% | 1° |
| Molybdenum | 21% | 14% | 3° |
| Silver | 14% | 5% | 8° |
| Gold | 8% | 2% | 14° |
| Rhenium | 52% | 52% | 1° |
| Industrial mineral | | | |
| Natural nitrates | 100% | 100% | 1° |
| Iodine | 24% | 61% | 1° |
| Lithium | 58% | 35% | 1° |

Table 1: Global importance of Chilean mining

Undoubtedly mining has been for many years the cornerstone of the Chilean economy and, in this context, copper mining stands out above all extractive mining activity. Some figures show the above mentioned:

- Chile contributes to 32% of global copper production
- Chile has 28% of detected copper reserves in the world
- Copper exports represent 55% of the country total exports

Chilean Public finances have benefited in recent years from the boom in copper prices (super cycle). The main effects of high prices for period 2000 - 2008[2] are: an increase on central government savings, which has gone from a deficit to a surplus; an increase in net tax revenue and contributions made to the Treasury by CODELCO, and the accumulation of resources in special funds, among others.

1 *"Competitiveness of Chilean Mining"; Presentation by the Vice President of COCHILCO at the publication of the 1993-2012 statistical yearbook of the institution, June 19, 2013*

2 *"Efectos del Cobre en las Finanzas Públicas Chilenas", José Yáñez, Revista Contabilidad y Sistemas, Depto. Control de Gestión y Sistemas de Información, Facultad de Economía y Negocios, U. de Chile, 2008.*

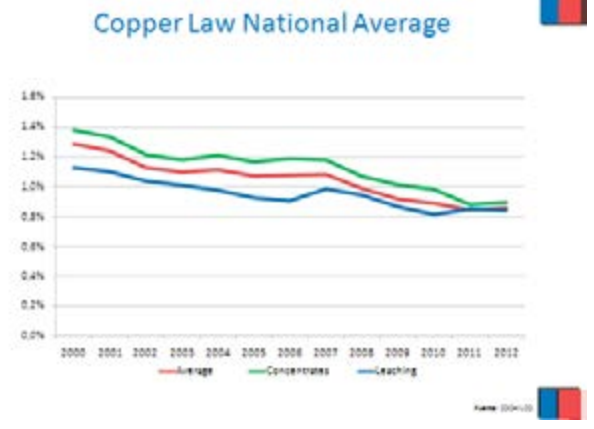
Indeed, the budget statistics on the Central Government's tax revenues (2000 - 2011) show that 73% are from tax revenue source, 12.2% are from the CODELCO contributions (taxes and transfers), 6.1% from withholdings, and the rest from various sources (donations, property income, operating income, etc..).

Regarding income tax, the Revenue Monitoring Report 2010-2012 published on the SII website notes that mining companies represent 30.2% of the total monthly first category income tax advance payments. If we add the specific tax provisional payments to mining withholding and the payment of the additional tax, mining companies provide 35.9% of monthly payments of income taxes. In this line, when analyzing the evolution of copper nominal price (annual average, London Metal Exchange) and the ratio of the income tax on tax revenue, direct correlation between the two variables can be observed (coefficient 0.95).

Another element to consider comes from the statistics compiled by the Chilean Copper Commission (COCHILCO) in its Monthly Bulletin, which states that in the period 2008-2011, 99.7% of the copper production was exported. Moreover, between 2000 and 2011 more than 99% of copper physical shipments, measured in metric tons of fine copper are reported by CODELCO and large mining companies (GMP). On average CODELCO participation reaches 33.3%, while GMP reaches 66.5%. According to the latest COCHILCO bulletin, the number of mining companies (CODELCO and GMP) for these figures is less than 30 companies.

Along with the copper price super-cycle, the cost of mining production has increased, which is partly explained by the depletion of ore deposits grades and the increase in the cost of strategic supplies (see charts below).[3].

3 *"Competitiveness of Chilean Mining"; Presentation by the Vice President of COCHILCO at the publication of the 1993-2012 statistical yearbook of the institution, June 19, 2013*
*According to Brook Hunt nomenclature C1 represent the cost of the mine plus the cost of facilities, plus the general costs and the sales costs.*


Regarding the technical complexity of this industry in terms of production and transactional processes, different control mechanisms are needed for monitoring the tax associated with this sector of the economy.

## 3. MINING TAXATION IN CHILE

From a tax perspective, the mining sector is defined as an activity essentially linked to commercial extraction, production and marketing of non-renewable mineral resources, except for hydrocarbon fuels.

The legal nature of the companies that can perform mining activities varies: corporations, limited liability companies, partnerships, cooperatives and public enterprises. There are also small businesses or artisanal miners (pirquineros).

### 3.1. Tax regimes

The first category income tax applies to income from all mining companies, regardless their size, type of organization or location. Determining the taxable income allows classifying taxpayers into three groups:

- Effective income: this category includes corporations and limited joint-stock partnerships; mining producers with annual sales exceeding 36,000 tons of nonferrous metal ore or which annual sales, whatever the mineral, exceed 2000 Annual Tax Units (UTA), and miners who elect to pay under this category.

§ Presumptive income: This category includes medium and small producers which are not taxed on real income, and small-scale miners who choose to be taxed according to the presumptive income

- Single tax: applicable to small-scale miners, who personally work in a mine and / or a mineral benefit plant, self-owned or not, with or without the help of their family and / or up to five waged employees. This legal definition also includes mining companies with no more than six partners and mining cooperatives, when all the cooperative partners are artisanal miners.

### 3.2. Specific taxation of the mining activity

Title IV (bis) of the Income Tax Law establishes a specific tax on the operating income of mining activity obtained by a mining operator. Articles 64 define the tax subjects, the taxable event, and the tax base and tax rates.

In summary, the aforementioned tax applies to the operational taxable income of mine operators according to the following:

- Mining operators which annual sales are equal or less than a value equivalent to 12 thousand metric tons of fine copper are exempt from this tax.

- Mining operators which annual sales are equal to or less than an amount equivalent to 50 thousand metric tons of fine copper and above 12 000 metric tons of fine copper, a rate according to the table established in the Law is applied .

- Mining operators which annual sales are more than 50,000 metric tons of fine copper pay a progressive rate according to the operational mining margin, from a table established in the Law

### 3.3. Foreign investment (law decree n°600)

According to the statistics of the Foreign Investment Committee of Chile (www.ciechile.gob.cl), from 1974 to 2011, mining (34%) and electricity (18 %), followed by Telecommunications and Financial Services (9%) are the economic sectors that have received most foreign investment in Chile.

The Foreign Investment Statute, Decree Law No. 600, is very important for the Chilean mining industry since it governs investment contracts agreements between foreign investors and the Republic of Chile. It has two tax options applicable to these investments:

- A fixed rate of 42% as a total effective tax burden, or

- The general tax regime of the First Category Tax and Additional Income Tax.

Under the provisions of Decree Law No. 600, mining companies which had signed investment contracts before the entry into force of this law in 2005, that establishes a specific tax for mining, and its 2010 amendment had the option to adhere to this tax treatment with some royalties related to a decrease of rates according to each contract period.

## 4. MINING CONTROL WITHIN THE INSTITUTIONAL CONTEXT IN CHILE

The control of the mining activity in Chile has different aspects and actors. One is the National Service of Geology and mining for the administration of exploration, exploitation and control of mining safety; environmental permits for exploration and exploitation are delivered by the Superintendence of Environment. The control of copper contracts exports and their derivatives is performed by the Chilean Copper Commission; the National Customs Service is responsible for export controls and the internal taxation control is under the Internal Tax Service. The following is a brief description of each of these institutions that together constitute the institutional monitoring of mining in Chile.

### 4.1. National service of geology and mining

The National Service of Geology and Mining, known by its acronym SERNAGEOMIN, is a decentralized public service and autonomous legal entity. Under the Ministry of Mining, it contributes to the geological and geophysical knowledge of the country.

Its strategic objectives are, among others: to assess the State regarding mining property, to develop the Chilean mining statistics and control the mining safety conditions. Regarding this last objective, SERNAGEOMIN seeks to increase the quantity, quality and coverage of mine safety inspections on site in order to decrease accident risks. It also promotes, regulates and monitors projects operation and closure of mining pits in small mining operations, and must timely answer to environmental authorities regarding environmental impact assessment within its competences.

### 4.2. Environmental superintendence

The Environmental Superintendence (SMA) is a decentralized public service with legal status, and is subject to the supervision of the President of the Republic through the Ministry of Environment.

The SMA is specifically in charge of executing, organizing and coordinating the monitoring and control of the Environmental Qualification Resolutions; of environmental prevention plans and / or decontamination plans, of the Environmental Quality Regulations and emissions standards, Management Plans, when applicable, and all other environmental instruments established by law.

The SMA develops three types of monitoring: a direct control, through its own officers; another through sectorial agencies, responsible for certain inspection tasks based on specific programs and subprograms for this purpose, and, finally, through third parties duly accredited and authorized by the Superintendence.

The Environmental Superintendent has the authority to apply sanctions against private or public entities that violate environmental regulations. Sanctions involve enforcing a set of principles and standards for ensuring that the decision is consistent and well- based: i.e. a predictable answer to noncompliance, through a rational and fair procedure.

### 4.3. Chilean copper commission

The Chilean Copper Commission (COCHILCO) is a highly specialized technical agency established in 1976. Since then it advises the Government on copper and byproducts production, and for all metal and nonmetal mineral substances except coal and hydrocarbons.

It also protects the state's interests in mining companies by controlling copper export contracts and evaluating their management and investments (especially in relation to foreign investment), and assesses the Finance and Mining Ministries in planning and monitoring their budgets.

The COCHILCO management areas are part of the Directorates of Education and Public Policy, Control and Evaluation of Strategic Management. They have key functions such as statistics, reports and studies relevant to the mining sector, audit of state mining companies management (Codelco and Enami), and assessment to the ministers of Finance and Mining.

### 4.4. National customs service

The National Customs Agency (NCA) is an autonomous public service with own assets, under the executive branch through the Ministry of Finance.

This service is responsible for monitoring and controlling the transits along the coasts, borders and airports, collect import and export duties in international traffic, and generate statistics on cross-borders traffic. This derives from its customs authority, i.e., the power to control entry and exit of goods to and from the country and to comply with the laws and regulations governing customs procedures. People crossing the borders, ports and airports are also subject to this authority, as well as the import and export of services for which the law requires the Customs intervention.

Its main strategic product is the clearance of merchandises, which include entry, exit, transit and free zone. Regarding the outputs and exports of goods, the mining sector represented about 64% of total exports in 2012. The NCA has established specific control procedures to certify the quality and content of concentrate ore shipped, in particular for the export of bulk or concentrated minerals.

### 4.5. Internal tax service

The Internal Revenue Service (SII) is a decentralized public service, with own assets, related to the executive branch through the Ministry of Finance. The SII, as well as Customs, is a state institution of Control. According to the law, its functions are the "implementation and control of all internal taxes and other taxes in which the Treasury has interest and which control is not attributed by law to a different authority. "The Tax Code and its Organic Law determine how to develop them. Basically, the SII is responsible for:

- Interpreting administratively the tax regulation, providing guidelines and orders for their correct enforcement and control

- Overviewing compliance with tax laws and defend the tax authority in court regarding ligation about application and interpretation of tax regulations

- It must develop the taxpayers' tax ethics and inform them about the use of their taxes and the sanction they face in case of not complying with their duties

The Internal Revenue Service, in line with other tax administrations, has created in 2001 the Large Taxpayers Division (DGC). This operating unit includes the 1500 largest taxpayers nationwide, which is approximately 65% of the national taxation. These groups of companies meet certain requirements established by resolution; they specifically states that Large Mining taxpayers are under the jurisdiction of this unit. The DGC is organized to control the mining mainly through the Audit Group No.2 (mining industry group) and Audit Group No. 6 (transfer pricing group) from the Large International Companies Department and the Foreign Trade Control Department, respectively.

## 5. TAX AUDIT TO MINING IN CHILE

The following is a brief review of audits to the mining industry in Chile, starting with a review of a mining project cycle and its tax incidences, and the generic structures of the mine holdings in Chile are also outlined. In addition, we provide information on the process of designing a tax audit and a description of the controlled variables. It also provides an example of audit and a detail of audit best practices resulting from the experience of the Large Taxpayers Directorate. Finally, we present some results and raise some issues that may challenge future audits.

### 5.1. Life cycle of a mining project

There are several ways to present the life cycle of a mining project. However, in most available models the common denominator can be explained through the following phases: discovery and exploration, pre-feasibility, feasibility and development, construction, operation and mine closure.

As shown in Figure 1, each of these phases or stages presents events or transactions that generate a series of tax effects, which must be considered when making an audit.

When dealing with a mining company (extraction and mineral processing) which is vertically integrated, i.e., present at every stage of the project, the expenses that occur at the stages prior to operation are called operating and start-up expenses and they have a special taxation rule.

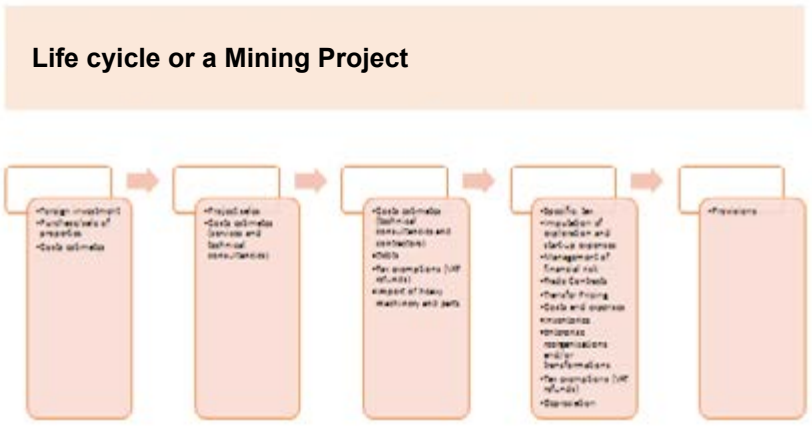



Figure 1: Taxed events through the phases of a mining project

However, if the mining company is not vertically integrated but organized in a specific holding structure (see section 6.2), each event will be taxed according to the adopted business configuration. In this sense, for example, the exploration costs will be located in the holding company that performs this function, and similarly for the common administration services.

### 5.2. Large private mining companies structures in Chile

While all the big miners have different corporate structures, we can identify some common elements, which have been outlined in Figure

2. Usually, the adoption of a holding type organization depends, among other reasons, on the mining project cycle, strategic definitions by owners (e.g., to maintain the mineral exploration under one's control), on the investment volume (forming consortiums), and on the laws of each country (mainly labor and tax laws).

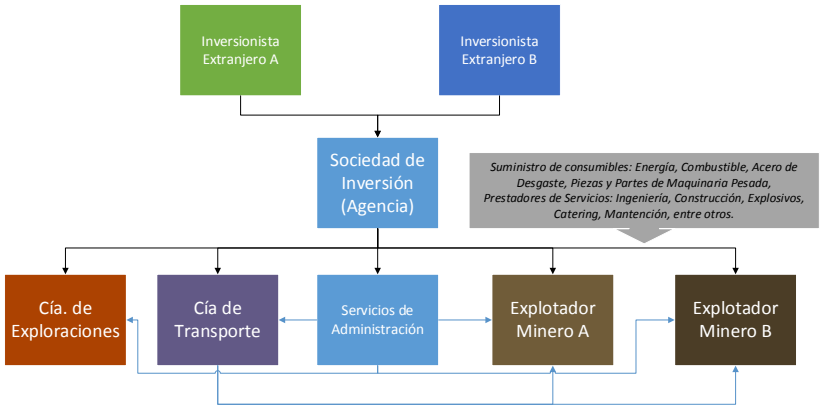



Figure 2: A Mining Holding Scheme in Chile

Due to the scale of investment required, most of the projects associated with large mining require the creation of consortiums by large multinational corporations. The diagram in Figure 2 illustrates this fact by identifying foreign investors (A and B), which generally create an investment company (agency) in Chile.[4]

How a holding mining group will be structured depend on each case. Some common elements are:

- In general, the various companies of a holding share, for example, management services (including accounting and financial).
- It is also possible to observe that - either by restrictions that imposes the regulations relating to the specific tax on mining activity or by the logic of their business units - holdings tend to keep separate the different mining projects.
- On the other hand, and considering both the business risks and the strategic aspects, many holdings decide to have a company exclusively for mining exploration.
- For labor economic reasons, they also seek to outsource all the services that are not an essential part of the mining business.

4 *There are also cases where the foreign investor directly operates the mining exploitation company.*

- Holdings established medium- or long-term relationships with providers of most important consumables goods (energy, fuel, steel, and parts).
- Given that power supply is critical, many mining holdings are part of consortiums linked to the power generation sector.
- Finally, those holdings that export bulk products (copper concentrate for example) tend to consolidate all the mining business. Thus, concentrates usually go to refineries from the same group while another group company is responsible for the final sales.

### 5.3. Audits process

The Tax audits process can start from two sources: from SII of or from the taxpayer, on occasion of any special requests (for example VAT refund claim for export or fixed assets).

Audits from SII may come from the National Directorate or from the Large Taxpayers Directorate. In both cases the audit design follows the same process, starting with identifying an elusive figure, then the approach of a working hypothesis, the objectives to achieve, the strategy for control and the specific actions to execute the control.

Finally all the work is documented through an instructions control guide and attachments that allow to support the work to be performed, which are submitted, before the execution of the audit, to the opinion of the operational units that will review them.

Below is a more detailed description on each stage of the audit process:

- **Identification of the elusive figure to control**: the figure is linked with non-compliance of tax law and/or SII guidelines. The identification is based on information about the taxpayer and the economic or business sector. It can also result from a monitoring to a particular taxpayer, or from press news.

- **Taxpayers' selection criteria**: are defined as logical rules leading to detect tax noncompliance characteristics or patterns. Based on these rules and criteria, it is possible to identify a set of compliant taxpayers.

- **Working hypothesis**: It refers to the definition of evasion, mainly based on the detected elusion behavior.

- **Goals to be achieved**: They include the hypothesis fact and legal support, identifying its elements, noting the main facts leading to demonstrate or verify through the audit that allow determining the differences and collect the applicable taxes.

- **Control strategy**: corresponds to the definition of planned actions of the audit, which will be materialized through the actions of control. This guides the review towards the verification of the working hypothesis and the fulfillment of the goals established.

- I**nspection actions**: correspond to concrete actions that control officials should carry out in order to obtain sufficient evidence that verifies the existence of the elusive figure identified.

- **Discussion forum**: It is a collaborative work to collect the opinion and experience of the operating units which will carry out the audit. These views and experiences are gathered for the efficiency and effectiveness of the audit.

Once the control program is created and validated by the operational units, the controlling officers of the SII perform the audit.

### 5.4. Controlled tax schemes

Within units responsible for controlling Large Mining Companies in the DGC, the tax schemes most frequently discussed are associated with aggressive tax planning, tax expenditure, tax-specific mining activities and transfer pricing.

#### 5.4.1. Aggressive tax planning

Corresponds to the use of elusive practices aimed at reducing the tax base, or moving it to obtain a minor tax burden or tax benefits. In relation to mining, the following can be observed:

a. Use of financial hybrids: operations that take advantage of the economic group's corporate structure, located in different territories, for investment enterprises to obtain returns without paying taxes, by hiding the concept as financial operations, with different tax treatments, allowing the non-payment of taxes in the involved territories.

b. Use of tax losses: since the Chilean tax legislation does not define a time limit for the extinction and carry-forward of tax losses, these can be used for reimbursing taxes paid related to profits; costs and revenues are moved from or out of Chile to generate or maintain negative tax bases.

c. Others: cover the price paid for the acquisition of a mining property as a payment for transfer of royalties; This allows the purchaser of the mining asset to deduce the total amount paid as expenditure in a single tax period, rather than in several periods according to the life of the mining site, as it is the case if the acquisition of a mining property is considered. In addition, the taxpayer provides that the highest amount obtained in the royalties' contract takes place abroad, through a related party not resident in Chile, so that the higher amount is not taxed in Chile.

d. Sales to related parties mineralized rock at a very low value, in order to reduce the taxation of the specific mining tax, and the related party sells it to the customer, obtaining a major income, which is not affected by the mining tax, since it does not qualify as mining agent, under the Chilean legislation

### 5.4.2. Tax expenditure

It is the use of non-tax expenditures to reduce profits tax affected by the First Category Tax - determined by applying the rate on the respective tax base. Their control requires knowledge of the mining activity and expenses and costs concepts, as well as the regulations and guidelines in force. For example pre-stripping and stripping expenses associated with the purchase of land for the tailing ponds have been examined to verify them.

### 5.4.3. Specific mining activity tax (IEAM)

The Chilean tax system establishes a specific Mining Activity Tax (IEAM), applied on a basis determined by deducing the associated costs from the income obtained exclusively from the mining activity. Therefore, it is important to determine that the taxed concepts effectively correspond to mining. On the other hand, the Decree-Law N ° 600 grants foreign investors the possibility of having an invariable tax burden for a number of years. However their constant changes, particularly with regard to mining, have resulted that the profits on these investments are taxed with different rates. Indeed, a company can be taxed at various rates depending on how many investment projects it has and what article of the DL N ° 600 is considered. In addition the related mining companies'

sales must be added for determining the rate. For these reasons, it is necessary to constantly analyze the applied rates, contracts and their modifications, and verify sales between affiliates, among others.

An example from the revenues' point of view is the mineral extraction from mineral waste, which is not taxed with the specific mining activity tax (IEAM). From the costs or expenses perspective the stripping must be treated as expenditure of the period, rather than considering it as extracted ore cost; the "provision for mine closure" must not be added; allocation costs common to the mining operational income (RIOM) must not be added either. Finally, and considering the applied rate, the invariable rate associated to mining projects from the general regime was applied to mining project which were under the general regimes.

### 5.4.4. Transfer pricing

Transfer pricing control focuses on the examination of cross-border transactions in which conditions and/or amounts different from those established by independent enterprises in normal market conditions are convened, so the review focuses both on the selling prices (calculation of the value of the cathode or concentrate) and their sales conditions, as well as the value of components or raw materials that are part of the product.

In this respect, it is observed:

a. Determination of the sales price of cathodes and concentrates: contract of copper supply between the taxpayer and related companies that set prices and conditions that are beyond the normal market ranges without an effective business reason.

b. Sales conditions to related traders: existence of copper supply contracts signed between the taxpayer and a related company (located in a territory of low or no taxation) which acts as a reseller (trader), by which a deduction is performed associated with the copper value and responding to transfers of functions and risks.

c. Sulfuric acid purchase conditions, as a component of the production process: the review detected a significant increase in the cost of sulfuric acid, one of the main components to produce coppers cathodes. When reviewing invoices and contracts, a great disparity in the prices of the sulfuric acid was observed, along with the existence of different suppliers, among which there were companies marketing the product, as well as producers, in addition to the existence of a fixed price in case of related suppliers.

d. Insurance and transport cost analysis: review of distribution basis for both concepts, which are mainly chosen centrally by the mining group headquarters located abroad.

e. Analysis of financial transactions: contracts, royalties and agreements to acquire rights in mineral production. In this case the operation corresponds to the purchase of a right (intangible) and involved the participation of the buyer in a percentage of the production sales.

### 5.5. Audits best practices

In the development of audits, the practices facilitating and helping to control large mining companies in Chile are identified as follows:

a. Field visits and meetings with the taxpayer, in order to meet the business and to contrast the accounting facts with the reality.

b. Meetings with other Public Administration agencies related to mining, such as SERNAGEOMIN and COCHILCO, and participate in events organized by these institutions or by the SII. This allows having information from other perspectives, in particular databases that the SII does not have, and develop collaboration to resolve queries from a source other than the taxpayer.

c. Good relations with audited taxpayers: thanks to good relations with managers of the controlled companies, explanatory visits to the productive processes have been organized, information is accessed in a quick and timely manner, and agreements have been achieved regarding controversial tax matters, avoiding losing resources in administrative and judicial instances.

d. Intra-group training: allow sharing personal knowledge, and it is a feedback mechanism with respect to revisions or control programs involving more than one mining company.

e. Exhibition of relevant cases: in which each different field team exposes their most important cases in terms of results or controversial issues. This allows having a different view with respect to the case, and sharing identification of evasive behaviors in different industries.

f. To maintain a continuous operational coordination between groups linked to audits on mining issues (auditing, transfer and foreign trade prices). This delivers a direct communication channel

to consult with respect to matters controlled by each group to a particular taxpayer.

g. External training, participation in seminars and lectures related to the category: so direct contact is created with agents involved in the industry (exploration companies, large suppliers, related government agencies, etc.), where issues and concerns that affect mining companies are analyzed.

### 5.6. Statistical background of applied audits

Between 2010 and 2012, 127 cases of audit to 58 large-scale mining companies in Chile were performed, which correspond to around 2.2 audits every 3 years for this group of companies, related to various tax issues. In average, for all companies at national level the rate reached 1.2. These indicators reflect the focus on this particular group of companies.

In April 2013, 63% of the above-mentioned cases were concluded and the average duration of these audits was 9 months. Depending on the type of tax or figure, the average duration moved in a range between 7 and 15 months. Table 2 shows more statistics relating to these cases.

| Tipo de programa | 2010 | 2011 | 2012 | Total x tipo | Distribución |
|---|---|---|---|---|---|
| Renta | 100% | 88% | 37% | 60% | 59% |
| IVA e IVA Exportador | 88% | 0% | 18% | 59% | 20% |
| Auditoría Integral | 75% | 100% | 100% | 82% | 11% |
| Tributación Internacional | 100% | 100% | 33% | 80% | 10% |
| **Total x año** | **91%** | **86%** | **34%** | **63%** | **100%** |

Table 2: Percentage of audits completed by type of program per year

As can be seen in table 2, 59% of the audit cases are linked to the income tax law, followed by 20% of VAT-related cases, 11% with comprehensive audits and 10% with international taxation. The following evolution of cases completed per year is observed: 91% for 2010, 86% for 2011 and 34% for 2012.

### 5.7. Tax figures to control in the future

In addition to the previous subsections, here are some issues associated with large-scale mining that have not been fully addressed by the SII. These tax issues represent challenges that must be met, given their importance for the mining industry, since they are following new forms of tax planning that in most cases are cross-borders.

### 5.7.5. Costs review

The tax control that the SII has carried out focuses primarily on incomes and tax expenditures, with a lesser emphasis on the analysis and review of the costs, including: energy, steel and parts, fuel, payment to contractors, raw materials, labor, etc. It has been shown in the press, and commented by the companies themselves, that observed variations in their results in recent years have been mainly due to strong variations in costs, which will continue to affect the future operations. This increase in costs would be compounded by the phenomenon of mineral deposits exhaustion.

### 5.7.6. Tax analysis of the holdings

As noted previously, some of the major mining companies in Chile are created with foreign capital, which have their matrix abroad and that are integrated both horizontally and vertically to improve their global performance. This is why inspections must include not only the partial vision of the extractive company but also the movements within the conglomerate of companies that make up the transnational mining holding company.

## 6. CONCLUSIONS

Given the importance of mining in Chile, the State has created an institutional framework to deal with these specific control issues and has promoted the cross specialization in institutions (as in the tax administration) to cover the various fields that this industry mainly impact. In particular, the internal revenue service has created working groups for the control of the large mining companies that are coordinated with other institutions in order to achieve better results in their audits. The SII also permanently promotes the training of its officials in order to keep up to date their knowledge about this industry.

In this context, there is increasingly more knowledge of mining cycle business, and its related processes, which is essential for the success of the tax audits, whenever differences are detected on a technically founded basis. The officers' training has been focused both from the institutional point of view (agreements with other entities), as from a good relations with taxpayers (companies) point of view which have transferred knowledge of an important part of their production processes through guided tours.

The mining industry is complex not only for their production processes but also because most of its transactions are transnational. Given

this reality, the holding structure increases the complexity of the tax control. In the Chilean case, most of the major mining companies are managed by transnational conglomerates with global operations.

These business groups structure their holding in Chile in order to minimize their tax burden and, in addition, their trade relations (exports) are made with related parties abroad.

In its audit work, the SII has developed in recent years audits with an emphasis on tax figures relating to aggressive tax planning, tax expenditure, tax specific to the mining industry and transfer pricing, from which it has been able to define the best control practices, for which coordination is needed. This coordination occurs at different levels: between working groups within the institution; between the SII and other institutions with competences in mining areas; and between control groups and mining companies.

The future challenges identified by the SII for the control of the large mining companies are increasing the capacity to address complex industry issues, such as the audit of cost and structure of these companies; in this last case the tax control focuses on the operations of the holding mining groups.

*Case Study*

*Topic 3.2*

# AUDIT OF THE MINING INDUSTRY

**Jane Stalker**
Coordinator
Industry Specialist Services
Canada Revenue Agency
(Canada)

***Contents:*** *1. Introduction. 2. Highlights of the Canadian mining tax regime. 2.1. General features of the Canadian mining tax regime. 2.2. Mining tax incentives. 3. Auditing Canadian mining corporations. 3.1. Risk assessment. 3.2. Areas of focus of a mining company audit. 3.3. Audit challenges. 3.4. Resources for CRA auditors. Conclusion.*

*Presentation PPT*

## 1. INTRODUCTION

Canada is a mining country, producing some 60 minerals and metals. It is also a global mining leader and accounted for 37 percent of world exploration in mining in 2012[1].

Although the financial returns can be lucrative, mining involves high risk and large capital requirements. It can take a tremendous amount of exploration work to find a feasible mineral deposit and then many years to develop the mine and bring it into production. Adding to these risk factors is the reality that mining companies are vulnerable to price volatility and cyclicality.

The Canadian tax provisions for mining entities recognize these commercial risks. Tax incentives not only encourage exploration and the development of new mines, they allow a mining company to recover much of its capital investment before paying taxes.

1 *Source: Natural Resources Canada*

Because of the special tax regime and the uniqueness of the industry, government audits of mining companies pose special challenges. The purpose of this paper is to discuss items the staff of the Canada Revenue Agency (CRA) focus on when auditing mining companies, as well as resources available to them.

## 2. HIGHLIGHTS OF THE CANADIAN MINING TAX REGIME

### 2.1 General features of the Canadian mining tax regime

Under Canada's federalism model, the country is divided into ten provinces and three territories with each having its own provincial/territorial government. Income tax is payable at both the federal and provincial/territorial level. The provinces and territories also levy a mining tax or royalty.

Considering the distinct commercial risks faced by mining companies (as noted above in the Introduction), there are advantages in the Canadian tax system:

a) The Canadian mining tax regime acknowledges the high risk and high capital nature of the industry by allowing for the recovery of much of the capital investment in a mine before taxes are paid.
b) Price volatility and the cyclical nature of mining are mitigated by not taxing non-profitable taxation years. Federally, taxes are based on taxable income which, generally, is calculated by deducting from revenue reasonable expenses incurred to earn that revenue. Similarly, most provincial and territorial royalties and mining taxes are based on net production profits, rather than gross revenue or net smelter production. There are also generous rules to carry back and carry forward losses.
c) Another advantage is that the mining tax regime in Canada is reasonably stable so that mining companies have more tax certainty as they plan for the long life of a mine.

Some complexities of the Canadian system are:

a) Other taxes levied by the federal and provincial governments are not profit based. Examples include payroll taxes, sales taxes and property taxes.
b) Special tax rules to address the uniqueness of the resource industry results in a complicated tax regime. This is magnified by the provinces and territories having their own mining tax or royalty regimes.

c) In general, the provinces and territories have jurisdiction over mineral rights for their land and their own sets of mining regulations.

**2.2 mining tax incentives**

Canada's tax system has several tax incentives for the mining industry aimed at encouraging exploration, the development of new mines and capital investment in mining. The overall aims are to increase economic activity, jobs and global competitiveness. These incentives include:

a) Canadian exploration expense.

This includes the costs of:

- "grassroots" exploration (initial phase exploration) - expenses incurred for the purpose of determining the existence, location, extent or quality of a mineral resource in Canada; and
- Pre-production development – expenses incurred to bring a new mine into development and incurred before it reaches commercial production levels[2].

These costs are accumulated in a non-expiring tax pool from which the mining company can make an optional tax deduction of up to 100% of the pool. The cost of depreciable property is excluded.

b) Canadian development expense

This includes:

- The acquisition costs of Canadian resource properties; and
- The cost of permanent underground work that is incurred after the mine comes into production.

Again these costs are accumulated into a non-expiring tax pool from which the mining company can make an optional tax deduction of up to 30% of the balance. The cost of depreciable property is excluded.

c) Accelerated capital cost allowance

Usually, the cost of depreciable mining property, (such as buildings, mills, equipment etc.) is eligible to be amortized for Canadian tax purposes at a 25% rate on a declining balance. However, if the costs

2 *To be phased out by 2017. Instead such costs will be Canadian development expense at a lower write off rate of 30 percent.*

are in respect of a new mine or a major expansion of an existing mine, they may be eligible for a 100% amortization rate[3].

d) Foreign resource expense

If a Canadian corporation has mining properties in other countries the company can accumulate the costs of these foreign mining properties, and exploration costs incurred in respect of them, in a non-expiring tax pool for each country. The company can claim a tax deduction of the lesser of its foreign resource income from that country and 30% of the pool balance.

e) Investment Tax Credit

A mining company can also earn investment tax credits on eligible exploration costs and pre-production costs of 5 % and 10 % respectively which can be used to reduce tax payable. They can be carried back for 3 years and forward for 20 years[4].

## 3. AUDITING CANADIAN MINING CORPORATIONS

### 3.1 Risk Assessment

Auditors at the Canada Revenue Agency analyze every large entity and prioritize high-risk files for audit. (See the paper by Canada on "Risk Analysis and Audit Software Tools".) Some of the risk factors we look at are:

- Whether the entity is a multinational corporation or group of corporations
- Whether tax haven countries are involved
- Whether the entity has a history of aggressive tax planning
- Whether potential audit adjustments would be material
- Industry issues, practices and trends
- Prior audit history of the entity
- Whether there has been a takeover, merger, major disposition or reorganization
- The tax situation of the entity (e.g. Does it have a series of loss years)

### 3.2. Areas of focus of a mining company audit

Since Canada has rich tax incentives for mining, it is important that

*3 To be phased out by 2020.*

*4 The 5 % credit for exploration expenses is being phased out by 2013. The 10% credit for development costs is being phased out by 2015.*

claims for those incentives by taxpayers are accurate. Accordingly our auditors ensure that expenses claimed as Canadian exploration expense, eligible for an up to 100% write-off, meet the tests in our legislation. For example:

- As noted above, there is a purpose test for eligibility of exploration costs; consequently, our auditors must verify that the costs are "for the purpose of determining the existence, location, extent or quality of a mineral resource in Canada".
- Pre-production expenses must be for the purpose of bringing a new mine in Canada into production. Consequently, auditors must verify that a project is a new mine as opposed to an existing mine or an expansion of an existing mine. On this issue, we often consult the geologists and engineers at Natural Resources Canada, a separate government department.
- Since eligible pre-production costs get this favourable treatment, the cut-off date of the pre-production stage is important, that is, the date when the mine reaches production in reasonable commercial quantities. Accordingly, our auditors must verify that claimed expenses are indeed pre-commercial production.

Other key areas of focus are:

- Reserves for mine closure, land reclamation costs and site clean-up. Although these are accrued for financial statement purposes, these future costs have not been incurred and are not deductible for tax.
- Acquisitions and dispositions of mining properties have specific tax rules.
- The point at which mining ends and manufacturing commences has tax implications.
- Transfer pricing – The auditor may need to verity that a cross-border transaction with a non-arm's length party was at a comparable arm's length (uncontrolled) price. This valuation is usually not difficult for many mineral sales if the minerals are in their final state, since there are public market prices for such commodities, which are easily verifiable. (It may be an issue if the mineral still has to be refined when it leaves Canada, for example, rough-cut diamonds or gold that is not at market purity.) The determination of the appropriate transfer price is a more contentious issue in respect of management fees and payments for know-how.
- Hedging – this is an issue for both commodity price hedging and foreign exchange hedging, particularly when the Canadian company hedges for related foreign companies.
- As in any other industry, our auditors would look at:

- Whether a transaction should be on income or capital account
- Foreign exchange transactions
- Whether the company is involved in aggressive tax planning schemes
- Whether tax haven countries are used in the company group
- Whether treaty shopping is involved.

### 3.3 Audit challenges

A challenge for our auditors in respect of the mining industry is that there may be a significant lag between when expenses are incurred by a mining company and when they are audited. It could take ten years for a mine to start making profits and paying tax.

The time lag challenge can be aggravated by staff turnover, which can be high at mining companies, particularly in northern Canada. This can cause difficulty in verification of the tax return.

Another challenge our auditors face is that junior (small) companies may have weak accounting and documentation systems due to their small size, few employees and lack of funds for other than exploration. For example, a lot of their work is contracted out and the invoice may not specify the nature of the work done.

Finally, it is our experience that no two mines are identical; accordingly, a site visit can be valuable to the auditor. However, the reality is that mines are located across Canada and often in remote locations and therefore site visits may not be logistically or financially feasible.

### 3.4 Resources for CRA auditors

Our auditors use the following resources when auditing mining companies

- Company annual reports
- Minutes of shareholder meetings
- Press releases
- The company Website
- Information filed with the applicable provincial or territorial regulatory body. This would include mining plans and reclamation plans.
- Stock analyst reports which may indicate mining history and plans
- A site visit when feasible.
- An internal CRA training course on mining taxation on our Website.
- Court case law

- The CRA Form T1134, on which the taxpayer must report on foreign affiliated companies and Form T106, on which the taxpayer must report non-arm's length transactions with non-residents.
- Internal and external databases e.g. CRA technical opinions, Statistics Canada, and external tax publishers.

The auditors can consult the Mining Specialist in CRA's Industry Specialist Services area. Our industry specialists are highly experienced in the audits of their particular industry and are an excellent source of technical assistance, industry related knowledge and commercial awareness. They give training and information sessions, and help auditors with the risk assessment and assessing positions of their files. The Mining Specialist also chairs a national Mining Steering Committee Meeting where CRA experts on mining meet to discuss and resolve current issues of national importance.

Our auditors can also consult or make referrals to other specialized areas within CRA, such as International Tax and Aggressive Tax Planning, or those responsible for technical interpretations. Outside of CRA, they may ask for the specialized knowledge of the geologists and engineers at Natural Resources Canada or the legal advice of the Department of Justice.

## 4. CONCLUSION

The mining industry is unusual in that it can take many years of exploration to find a mineralization that is feasible to mine, more years to develop that mine and the mine itself can stay in production for many years. (Some mines in Canada have operated for several decades.) Mining operations are also exposed to fluctuating prices of commodities and are vulnerable to profit and loss cycles. The Canadian tax regime for mining aims to mitigate these factors to some extent, while also encouraging exploration for the development of new mineral deposits.

CRA auditors of mining companies need specialized knowledge of this tax regime and the mining industry and awareness of which risk items should be focused on in their audits. Due to the global presence of Canadian mining companies, auditors also need to be alert for international audit issues such as transfer pricing. It has been our experience at the CRA that the best ways to address these needs are training, effective knowledge transfer, and the availability of dedicated experts both within CRA and in other federal government departments.

*Case Study*

*Topic 3.3*

# PREVENTION AND CONTROL OF TAX EVASION

**Joao Morais Canedo**
Deputy Director of the Tax Customs Authority
(Portugal)

***Contents:*** *Summary. 1. Introduction. 2. Monitoring and inspection / audit of telecommunications industry 3. Tax inspection / audit. 4. Specific tax risks for audits of telecommunications companies. 5. Conclusions.*

## SUMMARY

This paper is part of item 3 - Tax Audit: Market Segment Specialization Program, of the CIAT Technical Conference under the theme Tax Evasion Control and Prevention, which aims to present the operational approach of the Tax and Customs Authority (AT) in the field of monitoring and auditing companies in the telecommunications sector. In this industry, much of the activity is focused on a very small number of companies, structured in economic groups with international activity.

The methodology followed in this paper is based on the presentation of the organizational model of the tax inspectorate activities in the field of AT and, since much of the telecommunications business is focused on large companies that are under the supervision of Large Taxpayers Unit, in addressing the approach strategy of this Unit. It is based on the risk management program of tax compliance and the audit operational model, where there different stages of the process are carried out, from the preparation of an audit plan to the management of risk. It furthermore describes the most relevant tax risks of the telecom sector for each of the company transaction cycles, considering for each business knowledge, the identification and risk assessment and management of risks through audit procedures aimed at reducing risk to appropriately low levels.

At the end it is concluded that, given the high concentration of companies in the sector of telecommunications, we applied a model for continuous monitoring of all relevant companies operating in telecommunications. It was furthermore concluded that there are

significant tax compliance risk in the sector, with high probability of occurrence and high likelihood of evasion materializing.

## 1. INTRODUCTION

### 1.1 Tax and Customs Authority (AT)

The Tax and Customs Authority (AT) was established on January 1, 2012, by Decree-Law No. 118/2011, of December 15, as a result of the merger of the General Directorate of Taxation (DGCI), the General Directorate of Customs and Special Taxes on Consumption (DGAIEC) and the General Directorate of Information Technology and Support to Tax and Customs Services (DGITA), replacing the functions of the extinct agencies.

The Tax and Customs Authority is a national government agency empowered with administrative autonomy to manage decentralized regional units, under finance and customs directorates, and locally, under financial agencies.

The Tax and Customs Authority's main mission is to manage income taxes, estate taxes, excise taxes, customs duties and other taxes that may come under it by law, and to exercise control over border of the European Union and the national customs territory, for tax, economic and society protection purposes, in accordance with the policies established by the Government and European Union law.

It is a responsibility of the Tax and Customs Authority to verify that the goals of revenue collection by the State are met, in order to achieve the redistributive goal of the tax system and a more equitable and fair taxation.

To encourage voluntary compliance with tax obligations, the strategies adopted by the tax authorities must first implement measures to facilitate such enforcement, together with appropriate prevention and control measures, especially regarding the work of the Tax Office. Such measures must create in taxpayers the perception that noncompliance with tax obligations has a high risk of detection and punishment.

## 1.2. Tax and Customs Authority work under the AT

### 1.2.1. Operating organization

The Tax Authority is divided into several areas of operation, one of which is the tax office, which is responsible, among other tasks, to perform tax audits.

The Tax and Customs Authority is responsible for promoting compliance with tax and customs obligations, through monitoring of taxable transactions and the prevention and control of fraud and tax and customs evasion. It aims to provide an efficient service in the field of prevention, analysis and correction, in order to contribute to justice and fairness in taxation.

The performance of the Tax and Customs Authority aims to be a force for change in the image of the Authority and the importance of taxes for life in society, helping to maximize voluntary compliance with tax and customs obligations and to promote and ensure the safety of citizens.[1]

The Tax and Customs Authority operates on two territorial levels:

- Central level
- Regional level

### 1.2.2. Tax and Customs Authority work at the central level

The head office oversees two operating services directorates that combat tax fraud. They are the Fraud Investigation and Special Actions Directorate (DSIFAE) and the Customs Anti-Fraud Services Directorate (DSAFA) and the Large Taxpayers Unit (UGC). The latter performs, among other duties, the functions of tax examination for taxpayers who, given their economic and fiscal importance, are considered large taxpayers.

Taxpayers assigned to the Large Taxpayers Unit, for the purposes of inspection and tax management, are selected based on two main indicators: volume of business and total amount of taxes paid. A summary of the corresponding classification follows:

*1* National Activity Plan of the Tax and Customs Authority for 2013

Monetary Unit: Million €

| SELECTION CRITERIA | N.º taxpayers | Total Sales | Total paid taxes | % execution OE 2011 |
|---|---|---|---|---|
| **Higher amount of sales** | | | | |
| Nonfinancial Companies (VN > 200 M€) | 156 | 102.889 | 9.224 | 29,9% |
| Banks and other financial institutions (VN > 100 M€) | 26 | 23.766 | 2.900 | 9,4% |
| Insurance companies (VN > 100 M€) | 17 | 5.309 | 462 | 1,5% |
| **Higher amount of paid taxes – companies not selected using the above criteria** | | | | |
| Nonfinancial Companies (IMP > 20 M€) | 60 | 5.985 | 2.294 | 7,4% |
| Banks and other financial institutions (IMP > 20 M€) | 2 | 16 | 104 | 0,3% |
| Insurance companies (IMP > 20 M€) | 2 | 0 | 78 | 0,3% |
| **Higher amount of global profits - SGPS, companies not selected using the above criteria (> 200 M€)** | 4 | 3 | 14 | 0,0% |
| **Companies comprising the groups covered by RETGS in which some of the member companies were selected based on the above criteria** | | | | |
| Controlling companies | 32 | 157 | 183 | 0,6% |
| Controlled companies | 548 | 7.937 | 547 | 1,8% |
| **Companies maintaining control over companies selected using the above criteria and which are not part of the group under RETGS** | 7 | 31 | 14 | 0,0% |
| **TOTAL** | **854** | **146.093** | **15.820** | |
| **State Budget Execution in 2011 (total tax revenues)** | | | **34,2** | **46,2%** |
| **State Budget Execution in 2011 (tax revenues excluding state-owned agencies delivering taxes > € 1,0) (M€ 3,343)** | | | **30.898,0** | **51,2%** |

### 1.2.3. Inspection at the regional level

At the regional level the tax office operates through 21 finance directorates and one regional autonomous office (Madeira), with powers of supervision and inspection over taxpayers located in their respective geographical areas, except those selected using the aforementioned criteria, who fall under the jurisdiction of the Large Taxpayers Unit.

## 2. MONITORING AND INSPECTION / AUDIT OF TELECOMMUNICATIONS INDUSTRY

## 2.1. Large Taxpayers Unit (UGC)

The telecommunications sector is highly concentrated, with six companies accounting for 90% of the volume of business generated. These businesses, given their economic and tax significance, are supervised and inspected in a centralized manner by the Large Taxpayers Unit (UGC).

In the field of tax administration, the UGC's mission is to oversee the taxpayers who come under it, encourage and support voluntary compliance of large customers' tax obligations, and oversee their tax behavior in an equitable fashion. This is done in keeping with a new relationship model based on cooperation and transparency processes between the parties.

The implementation of specific integration and coordination processes in dealing with large taxpayers enables the administration to perform

in a more effective and efficient manner, to improve quality of services rendered to taxpayers, and to reduce disputes.

Therefore, the Large Taxpayers Unit, in the framework of its mission, seeks to establish a relationship of cooperation and transparency with large taxpayers, which can foster voluntary compliance with tax obligations at the right time and for the amount owed. It aims to bring large taxpayers in line with legal provisions while promoting confidence in the tax system.

Objectives

The Large Taxpayers Unit bases its objectives on two main pillars:

a) Maintain and increase tax revenues from the major taxpayers by promoting voluntary tax compliance and ensuring that the tax returns of large taxpayers represent truly and appropriate their tax situation;
b) Reduce administrative and judicial tax disputes with large taxpayers.

**Strategies**

The strategies of the Tax and Customs Authority to achieve the objectives set for the large taxpayers emphasize a relationship based on the principles of cooperation and transparency, encouraging and supporting the respective voluntary tax compliance.

The main strategic work lines for large taxpayers are based on:

a) The segmentation of taxpayers, identifying low-risk taxpayers and those posing a higher risk, according to their level of tax compliance, cooperation and transparency;
b) Periodic review of compliance risks with regard to all taxpayers, on a voluntary and cooperation basis, providing the appropriate self-evaluation and sharing the vision of the Tax and Customs Authority on its position in the spectrum of tax compliance;
c) The implementation of a model of collaborative monitoring of tax compliance of taxpayers classified as low-risk taxpayers, based on a less intrusive relationship and predominantly based on the joint and periodic review of compliance risks;
d) Concentrating the work of inspection on high-risk taxpayers seeking, if there are corrections, to anticipate the final outcome of the inspection process and ensuring that it is likely or very likely for the taxpayer to voluntarily make corrections and pay additional charges, or obtaining a favorable decision from a dispute;

e) Providing customized technical assistance to low-risk taxpayers and higher-risk taxpayers, who may be considered important (key) for having a significant influence on the tax system and meeting the requirements defined for this purpose, through the institutionalization of specific interlocutors.

## 2.2. Tax compliance risk management program

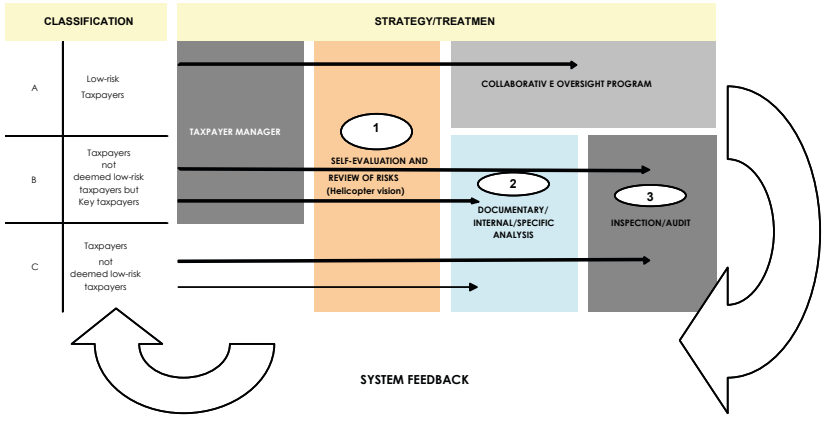
### 2.2.1. Model overview

The goal of the Large Taxpayer Unit, in terms of inspection and tax management, is based on a model of Tax Compliance Risk Management which generally aims to identify and evaluate tax compliance risks, and the election of the most appropriate risk strategy for each taxpayer, in accordance with defined strategies.

The model is based on three different levels of intervention:

- Review of tax compliance risks, geared toward all taxpayers (helicopter view);
- Internal analysis of the tax returns or any other document or accounting records considered important for taxpayers who require further assessment of the potential risks from the process of self-evaluation and review of the risks from the previous phase;
- Inspection / Audit, for taxpayers who are not classified as low-risk taxpayers, provided that there are specific tax risks or important information systems and internal controls in place.

In short, this model is developed according to the following process of classification and management of risks:



### 2.2.2. Review of tax compliance risks

The review of tax compliance risks consists of a strategy to improve the knowledge of the taxpayer on the basis of institutional cooperation, seeking voluntary compliance, self-regulation of noncompliance, and defining the appropriate approach for each taxpayer.

The purpose of a review of tax compliance risks is to enable the identification and assessment of taxpayers' risks, in conjunction with the Tax and Customs Authority, encouraging taxpayers' self-evaluation, to allow reducing these risks to appropriately low levels. This will furthermore allow minimizing the costs associated with procedures involving a significant allocation of resources from both parties, contributing to a reduction in disputes and the use of legal advantages derived from the timely resolution of non-compliance.

The review of compliance risks, once a year for most taxpayers, will determine whether additional procedures should be implemented for each taxpayer in terms of analysis of tax returns or specific or general inspection / tax audit.

The review level of tax compliance risks determines the classification of taxpayers who are low risk and higher-risk taxpayers, generally considering the following indicators:

| Group | Indicators |
|---|---|
| Importance and complexity – inherent risks | ▪ Potential economic yield<br>▪ Level of organizational complexity, international structures and related parties<br>▪ Susceptibility to frequent changes in society and the organization |
| Government | ▪ Cooperation<br>▪ Transparency<br>▪ Compliance record<br>▪ Tax debts |
| Information – control risk systems | ▪ The reliability of information and internal control systems |
| Specific tax risk – recognition of tax differences and tax planning | ▪ Recognition of accounting and tax differences<br>▪ Participation in tax planning not resulting from genuine commercial activities |
| Effective tax contribution | ▪ Efficiency and contribution in the IRC<br>▪ Efficiency in VAT<br>▪ Tax efficiency versus economic and financial performance |

### 2.2.3. Internal and documentary analysis

In this stage, after evaluation of the risks and focusing on higher-risk taxpayers, we aim to delve into issues involving the risk of compliance through analysis of tax returns and other accounting or tax documents, along with examining taxpayers. Our ultimate goal is to assess whether the risks are significant and work to lower them considerably, concluding in the end whether or not audit procedures are necessary for resolution.

### 2.2.4. Inspection/Audit

Inspection / audit are a limited resource so it should be predominantly geared toward higher-risk taxpayers. Its existence and functioning ensure fraud prevention and voluntary compliance with main and accessory tax obligations, providing a deterrent against tax evasion and tax fraud.

However, the idea that compliance and a true tax assessment are obtained exclusively through inspection procedures is not always valid, especially in the universe of large taxpayers. Forced compliance through additional assessments where sustainability is not always guaranteed leads, as a rule, to lengthy and costly litigation processes with uncertainties in the final outcome.

Consequently, the Tax and Customs Authority should focus on large taxpayers and a relationship that significantly reduces the use of investigative resources, mainly geared toward inspections / audits of higher-risk taxpayers.

## 3. TAX INSPECTION / AUDIT

### 3.1. Global strategy, approach process and audit plan

The audit process approach for accounting and taxation of businesses consists of the division of labor in the major transaction cycles of companies, which in turn are divided into accounting-tax areas, where each area is bounded by the accounts (balance sheet and income statement), that record transactions and events associated with each cycle and the fiscal framework of the underlying transactions.

The main cycles in business transactions are:

· Operating cycle covering accounting-tax areas of current expenses, revenues and inventories;

- Investment cycle, which includes the areas of investment accounting-tax in tangible and intangible fixed assets and financial investments;
- Funding cycle, which refers to the accounting-tax area of the business own equity and liabilities.

For taxpayers who in the area of tax compliance risk management program are found to require additional treatment - inspection / audit - an audit plan is drafted, based on two phases: the first one partially complementing the two preceding phases of identification and risk assessment, and the second in response to the assessed risks through the drafting of a specific work program and the definition of audit procedures to examine the accounts and tax information and related support documentation:

<table>
<tr><td rowspan="3" colspan="2">Audit Plan</td><td rowspan="3">Risk identification and assessment</td><td rowspan="2">Understanding of the business and its environment – inherent risk assessment</td><td>Analyze financial and tax information</td></tr>
<tr><td>Know sector and regulatory factors, the nature of the business, accounting policies, business risks</td></tr>
<tr><td colspan="2">Understanding the internal control system - control risk assessment</td></tr>
<tr><td>Response to risks assessed</td><td>Work Scheduling - definition of risk detection / definition of the procedures for obtaining the evidence</td><td colspan="3"></td></tr>
</table>

### 3.2. Identification and evaluation of audit risks

#### 3.2.1. The identification of audit risks

Business risks generally fall into two categories:

- Inherent risks arising from differences between accounting and taxation and tax planning structures that only affect taxable income, regardless of internal controls related to the company, and that relate to the company's business, governance model and tax features of the economy activity;

· The control risk, derived from the likelihood that information systems may generate information that could distort the accounting outcome and consequently the tax results, and which is not detected by the internal control systems of the company.

**Understanding the company and its environment - Identification of the inherent risks**

This is the first stage of planning and aims to identify the risks, by understanding the business and its environment, particularly the business activity, governance and financial and tax information for the period:

Knowing the company and its business activity means identifying trends and levels of economic, financial and tax performance that may influence the accounting and tax compliance results.

The situations to be considered in the business are particularly general economic factors, industry characteristics, type of business, type of product and / or goods and / or services, the markets in which it operates, location, competition.

**The telecommunications business sector**

In the context of planning work referred to above, in the stage of getting to know the company and the industry, it is clear that telecommunications is a sector regulated by Law No. 5/2004, dated February 10, which establishes the legal regime applicable to networks and electronic communications services and associated facilities and services and defines the authority of the national regulatory authority in the matter.

The regulator is ICP-National Communications Authority, hereinafter ICP-ANACOM, which, in the exercise of their functions, assumes the rights and obligations attributed to the State under the applicable laws and regulations, in particular as regards the public services, communications, their audit, the definition of crimes and the application of appropriate sanctions.

The incumbent owner of the fixed network in Portugal is PT Communications, which is also the largest national telecom operator.

The telecommunications sector in Portugal consists of 827 companies, legal entities, registered under the classification of telecommunication operators[2], which are subdivided into three sub-sectors and also in

2 *Economic Activity Code (CAE) 61 – Telecommunications, 2012 data, Source: AT*

a group of entities registered as other telecommunications activities, related to other ancillary telecommunications services and not engaged properly in signal transmission:

- Cable Telecommunications (198)
- Wireless telecommunications (57)
- Satellite telecommunications (10)
- Other telecommunications activities (562)

The total sales of this sector in 2012 amounted to € 6.908 billion, with the 6 major operators accounting for 90% of this amount, which also corresponds to 80% of the net income. This reflects a high concentration of the telecommunications activity, as shown in the following table:

**Year 2012** Unit: million of

| Taxpayers | Sales | Accounting result |
|---|---|---|
| PT COMUNICAÇÕES | 1.739 | -86 |
| VODAFONE PORTUGAL | 1.199 | 134 |
| TMN-TELECOMUNICAÇÕES MOVEIS | 1.153 | 251 |
| LYCATELCOM ZONA FRANCA DA MADEIRA | 758 | 0 |
| OPTIMUS-COMUNICAÇÕES | 730 | 63 |
| ZON TV CABO PORTUGAL | 653 | 30 |
| **Total for 6 major** | **6.232 (90%)** | **392 (80%)** |
| Other operators | 676 | 102 |
| **Total** | **6.908** | **494** |

According to the above table, the main telecom operators that exploit the mobile communications business and data are Vodafone, TMN, Optimus and ZON, and the major distribution, selection and services aggregation operators of television available to the public are Zon TV Cabo, PT Comunicações / MEO, Vodafone and Optimus. As highlighted above, PT Comunicações remains the largest fixed network operator.

Finally, another operator that appears in the table is Lycatelcom, a company owned by UK capitals and based in the Madeira Free Zone (with benefits of exemption from income tax), which is dedicated to providing virtual calling service cards.

The sales of telecommunications businesses in Portugal have been declining since 2010, with reductions between 4% and 7% in the last two years.

**The characteristics of the businesses in the telecommunications sector**

The situations to consider with respect to businesses subject to inspection / audit are, in particular, the business structure, capital owners, attitudes and policies of the partners and operations managers, personnel turnover, financial performance and the existence of conflict.

The financial and tax information of the business is obtained through information provided on the institution's website on the Internet, the management report, financial statements, statutory audits of the accounts, tax returns, simplified business information (IES), the process of tax documents, etc.

It can be seen, within this context, that the most important businesses operating in the telecommunications sector are companies with international capital, organized in economic groups listed on the Lisbon Stock Exchange (NYSE-Euronext) (PT, TMN, Optimus and Zon) and with multinational operations (Vodafone and Lycatelcom).

**Understanding the internal control system - control risk identification**

The control risk deals in particular with the organizational structure of the company, as a result of deficiencies in the systems of control and / or management negligence that may cause distortions in the financial statements and tax returns.

The main elements to be evaluated are the control environment, the information system - accounting system - and control procedures.

The purpose of this planning stage is to identify the weaknesses in controls related to real flows and financial flows, the accounting records of the transactions and the outside-of-the-books tax assessments.

**3.2.2. The evaluation of audit risks**

After identifying the risks, it is necessary to assess their impact on the audit reflected in two variables, i.e., the probability of occurrence and materiality.

The evaluation of the probability of occurrence aims to determine whether (the) risk (s) are likely to materialize in distortions from accounting income and / or tax (most likely it will not happen), probability to result in distortions from accounting income and / or tax

(most likely to happen than not) or highly probable, event almost certain to materialize in distortions in financial income or tax irregularities.

As for the materiality of the risk transactions or events, we assess if it is low, medium or high, considering materiality in this context as a relative quantity which refers to the main indicators of the company (billing, revenue accounting or the value of assets or equity), the value of the distortion of revenue and / or tax accounting which may be deemed to affect the opinion of users.

### 3.2.3. The response to the assessed risks

The Inspection / Audit is responsible for designing and implementing operating procedures in order to respond to the assessed risks of material misstatement of the financial statements and / or tax returns[3], with respect to higher-risk taxpayers who may show significant risks of compliance.

## 4. SPECIFIC TAX RISKS FOR AUDITS OF TELECOMMUNICATIONS COMPANIES

Among the compliance risks usually specific to the audited businesses, we want to highlight in this part of the paper, sector-specific tax risks and cross-sectional risks for the telecommunication operators, divided according to the cycles of business transactions.

### 4.1 In the Operating Cycle Audit

#### A) Payments for the use of satellite transmission capacity

#### A1) Knowledge of the business

Television and telecommunication companies operators often enter into contracts with non-resident companies (whose business is the management of the contracting of satellite capacity) providing for the transfer of rights to use the transmission capacity of issuers transponders (or transponders) housed in the satellites, in order to obtain the signal for television channel transmission.

Taking into account the characteristics of the aforementioned contracts as well as the elements comprising the lease contract, the Tax and Customs Authority considered until 2009 its use as an operating lease, while taxpayers saw it as a contract to provide services.

3 *ISA 330 (Corrective Return) – The reponse of the auditor to the risks assessed – OROC, 2010*

From the position of the AT, it was concluded that income paid would qualify as "income from the use or right to use agricultural, industrial, commercial or scientific equipment" and therefore considered as earned in Portugal and herein taxed by way of withholding at the source.

As payments for non-residents are considered as withholding at the source taxes, in the field of the Double Taxation, some[4] include wages (income) paid for the "use or right to use industrial, commercial or scientific equipment" under the definition of royalties, being the withholding tax thus owed at a rate of between 5% and 15%.

But the 2010 version of the Model Convention for the Avoidance of Double Taxation clarified in paragraph 9.1 of the comments on Art. # 12, not only that these payments are not royalties but also that "they are not made for the use or the right to use goods (....)." But it said that "in regard to conventions including the leasing of industrial, commercial or scientific equipment under the definition of royalties, the classification of income depends on each contract, concluding that, in cases in which the client (broadcasting and telecommunications companies) do not run transponder issuers (or transponders) for not having physical access to it, then the payments are treated as services to be included in Art. 7 of the CDT and not as income from the use or concession for use of the equipment"

From the classification made by taxpayers as providing services under the conventional provisions, the withholding at the source tax rate is 0%.

Up to 2009, inclusive, from this divergence in classification and differential in withholding rates resulted corrections in the field of audits, pending the decision on the classification of the incumbent operator in the tax classification on this income, which according to national law is not considered as earned in the country.

**A2) Identification and evaluation of specific fiscal risk**

The risk arises from the different classifications of income (services provision or royalties) paid to non-residents businesses, derived from the use of satellite transmission capacity under contract.

4 *This stems from the definition of royalties in paragraph 2 art. # 12 of including only up to the 1977 MCDT version, "the remuneration paid for the use or concession to use industrial, commercial or scientific equipment," subsequently included in the definition of royalties to the choice of each country.*

Specifically, the risk lies in considering wrongly, under the contract that the client does not run the transponders (or responder) and therefore income should be classified as communications services, when they should be "income from the use or the right to use agricultural, industrial, commercial or scientific equipment" and therefore included in the definition of royalties under certain CDT.

(CIRC, Articles 4, 94 and 98)

**A3) Response to Assessed Risks - audit procedures**

i. Analysis of Financial Statements for the identification of these contractual positions (as a rule they are recognized in the form of financial lease, not intangible assets[5]);
ii. Confirm the nature of income through the analysis of contracts;
iii. Analyze the Declaration Model 30 - Payments to non-residents businesses for the settlement of payments made;
iv. Analyze current account of the provider, satellite holder, to measure the time of income payment and the withholding rate;
v. Validate RFI forms (for withholding at the source).

**B) Allocation of points in mobile communications**

**B1) Knowledge of the business**

Communications companies have loyalty programs for some of their customers, under which, according to their consumption, they are entitled to loyalty points that can be redeemed for equipment, accessories and discounts on subsequent purchases of services. In the absence of accounting standards or interpretations regarding the accounting for customer loyalty programs, companies within the SNC adopted the interpretation "IFRIC 13 Customer Loyalty Programs" (IFRIC 13)[6].

5 *For accounting purposes, the taxpayer records this financial contract in accordance with International Accounting Standard 17 - IAS 17 - Leases, establishing appropriate accounting policies in respect of the Financial and Operating Leases. Therefore, the contract under consideration is recorded as assets and liabilities on the balance sheet for the contract value on the date of acquisition.*

6 *In POC companies account for these transactions recognizing under profits the total amount received by the traffic consumed and recording a provision to deal with the cost estimate derived from the use of earned points.*

The interpretation requires that under these transactions, the amount initially received be allocated to consumed traffic-related revenues and the points the customer earned for recording revenue to be recognized. The accounting treatment to be made under the basis of IFRIC 13 is incompatible with the Portuguese tax rules under the Code of Corporate Income Tax[7].

**B2) Identification and evaluation of specific fiscal risk**

In the telecommunications sector, especially in the context of mobile communications there is an allocation of points, with recognition being made in accordance with IFRIC 13, which differs from the fiscal rule for recognition of the service provision established in the Income Tax Code. Therefore, there is the risk of failing to consider income for service provision in the fiscal area, legally speaking, if the taxpayer does not include in the tax base, for the respective year, the amounts deferred for accounting purposes.
(IFRIC 13)

**B3) Response to Assessed Risks - audit procedures**

i. Assess whether the taxpayer can apply to IFRIC 13
ii. If applicable validate whether the amounts deferred in the accounting year have been added to the Income Statement
iii. Validate whether the amounts transferred annually to an accounting profit are deducted from the Income Statement

**C) Tax credit for international double taxation**

**C1) Knowledge of the business**

When the resident companies, included in telecommunications economic groups, make profits abroad derived from service provision and royalties, these are subject to withholding at the source taxes under the law of the State of origin, or by activating the CDT, as appropriate, at a reduced rate. The income is also taxed in Portugal, according to the principle of global taxation, under the Code of Corporate Income Tax.

This juridical double taxation can be mitigated by deducting the collection of income tax (IR) (i) of taxes paid abroad, (ii) a fraction of the IR or (iii) the tax due when CDT may apply in legal terms under certain conditions.

7 *Art. No. 18, No. 3 b) of the Income Tax Code*

**C2) Identification and evaluation of specific fiscal risk**

Economic telecommunications groups generally provide services outside their national territory, using the tax credit for international double taxation (CDI) to avoid double taxation. Therefore, the associated risk can be seen, especially when assessing a fraction and conditions for deduction for failure to meet conditions, i.e. (i) failure to provide proof of tax paid abroad, (ii) a tax deduction greater than allowed (in particular, if the calculation of a fraction of the IR at the tax rate is levied on gross income instead of net profit) , (iii) deduction of the tax paid and not the tax payable under the terms of the CDT and also (iv) the deduction of tax still unpaid despite income being already included in the tax base.

**(CIRC, Art. No. 91)**

**C3) Response to Assessed Risks - audit procedures**

i. Check the information of income earned abroad, by amount, country of origin and payer, and the documentary evidence issued by the tax authority in the manner in which the tax was paid in the respective country;
ii. Check the charges associated with obtaining income and payment and receipt documents for these payments;
iii. Evaluate whether the income earned abroad are recorded as revenue in the year under review;
iv. Compare the tax paid abroad, duly confirmed by the taxpayer, and the fraction of income tax (IR), calculated before deduction corresponding to the revenue that the country in question may tax net of expenses or losses, either directly or indirectly, incurred in obtaining it;
v. Check whether the amount of the tax credit for international double taxation deducted at the time of collection, matches the lesser of the following amounts:
    - Income tax paid abroad;
    - Fraction of the tax, as computed before the deduction attributable to the income that the country in question may tax net of expenses or losses, either directly or indirectly, incurred in obtaining it
    - Taxes paid abroad, in accordance with the Convention for the Elimination of Double Taxation signed by Portugal, where present.

## D) Payments to non-resident businesses

### D1) Knowledge of the business

In the communications sector there are often payments made to non-resident businesses arising from the purchase of *software* licenses to be embedded in mobile phones or for the development of specific computer applications and their respective service contracts, on which the withholding tax at the rate specified in national law is due, or the rate of the Convention for the Elimination of Double Taxation, if there is one and it is enacted properly.

### D2) Identification and evaluation of specific fiscal risk

In the telecommunications sector there are frequent overseas purchases of licenses for the use of software to be embedded on mobile phones or computer systems, and their respective service agreements, which are associated with payments to non-resident businesses. This is associated with the risk of classifying payments as services when they should be deemed royalties.

This risk mainly arises if, in the field of treaty rules, the taxpayer considers paid income as services (withholding at a rate of 0%) therefore failing withhold any tax, when they correspond to royalties, being then due to a withholding tax at the source at a rate ranging between 5% and 15%, depending on the CDT.
(CIRC, Arts. No. 4, 94 and 98)

### D3) Response to Assessed Risks - audit procedures

i. Assess through the analysis of Financial Statements and the Annual Report and Accounts economic data to justify payments to non-resident businesses (for instance the No. of: additions during the fiscal year to tangible fixed assets (basic equipment) or intangible assets (licenses);
ii. Analyze the Declaration of Payments to non-resident businesses, in order to identify all payments made to non-resident businesses;
iii. Select the most significant payments and those over which no withholding at the source has been made;
iv. Analyze the contracts with previously selected non-resident businesses for the classification of income and if it is determined by the classification of the royalties, analyze the current account of non-resident supplier to determine the time of payment of income and if the withholding was made at the appropriate rate and time;
v. Request the RFI forms, if there is a CDT in place.

**E) Allocation to officials who provide free services**

**E1) Knowledge of the business**

In the context of an aggressive commercial customer loyalty policy, telecommunications companies are offering their employees and their families, benefits like discounts and special conditions for the purchase of goods and services in shops, through established protocols with the respective telecommunications brands and electronic equipment. There are cases in which the service is provided free of charge.

**E2) Identification and evaluation of specific fiscal risk**

Telecommunications companies sometimes assign free services to their employees, the risk of which consists in employees' failure to pay income tax and VAT.

**E3) Response to Assessed Risks - audit procedures**

i. Identify and specify the benefits granted to workers;
ii. Identify the list of workers covered by the benefit and their respective estimation in legal terms.

**4.2 In the Audit of the Investment Cycle**

**F) Tax benefits – Investment Assistance Tax Regime (RFAI)**

**F1) Knowledge of the business**

The Investment Assistance Tax Regime (RFAI) was created by an autonomous law in 2009 to enter into force only that year, but was later extended to the State Budgets for 2010, 2011, 2012 and 2013[8].

This benefit was offered to certain economic sectors, including bandwidth, which includes telecommunications companies, as well as providers of mobile, fixed and television services distribution operators[9].

*8 Article No. 232. OE 2013 Investment Assistance Tax Regime*
*"The investment assistance tax regime introduced in 2009 (RFAI 2009), adopted under Article 13. of Law. 10/2009, of March 10, remains in force until December 31, 2013."*
*9 Law No. 2/2007, of 30.07, Art. 2, No. 1, e) «Distribution Operator» the company responsible for the selection and aggregation of television program services and making them available to the public, through electronic communications networks;*

The tax benefit consists of a deduction in collection up to an amount equal to 25% thereof, an amount equal to 20% (investments up to 5 M €) or 10% (investment of over 5 M €) of investments in tangible and intangible fixed assets, with some restrictions, such as buildings and vehicles. These limits may be lower, if the investment is made in regions with lower rates, according to the national map for state aid for regions.

**F2) Identification and evaluation of specific fiscal risk**

As a sector using investment tax benefits, since it covers broadband investments, the risk involves (i) inadequate consideration of ineligible assets, (ii) the deduction for amounts exceeding the limits, (iii) the sale of asset before the expiry of their mandatory ownership term (five years) or (iv) reporting for subsequent years of benefits deductible in a given year, as a form of IR payment management.

**(Law No. 10/2009, of March 10)**

**F3) Response to Assessed Risks - audit procedures**

i. Identify taxpayer under the Income Tax and the activity under which it is registered, and the effective year for the activity;
ii. Compare with eligible activities for RFAI purposes;
iii. Check under the Fiscal Documentation Process for the taxpayer the required documentation: document confirming the absence of tax debts, the justification of the benefit (calculation), the supporting document of the relevant investment; uncollected tax;
iv. Check if the investment declared by the company is consistent with increases in tangible fixed asset accounts, intangible assets and investments in progress in the notes;
v. Consult the detailed list of investments classified by the taxpayer as relevant and build a representative sample of the universe with the use of statistical techniques and analyze the documentary sample selected for the test: eligibility (for instance, land, construction and expansion of buildings), the acquisition as new, acquisition during the year;
vi. Estimate the corresponding investment, taking into account the legal provisions and the result derived from the documentary analysis and classify using the codes governing tax depreciation;
vii. Build a map to oversee the maintenance of the corresponding investment until the end of the subsequent four years;
viii. Check the list of jobs created in the year as required by RFAI, identify work (function), workers (name, number of employees and NIF) and the type of contract and the relationship with the

investment made, demonstrating the estimation of the net increase occurred in the year and the average for the last 12 months;

ix. Calculated on the basis of relevant investment the tax benefit for the tax benefit not deducted in previous years due to insufficient data collection, the tax benefits calculated for the year and the limitation (up to 25% of collection);

x. Develop a tracking map for the RFAI benefit;

xi. Check in the next four years after introduction, the validity of budgets containing tax benefits: Intangible fixed assets that include assets under the benefit and retention of employees, or their replacement by others, the keeping of the job and whether the assumptions hold, estimate the unpaid IRC proportional to the value of goods that have not been maintained or termination of the right to benefit if the net creation of jobs is not corroborated.

**G) Expenses for the dismantling of tangible fixed assets**

**G1) Knowledge of the business**

Telecommunications companies often incur expenses for the removal of antennas located on the property of others, covering not only the removal itself, but also the restoration of the respective property at the end of the use period.

After 2010, with the introduction of International Accounting Standards, the initial estimate of these costs is included in the cost of tangible fixed assets if the cost is amortized. However, the Portuguese depreciation tax code states that, for the purposes of calculating the respective quotas, asset components should be valued at cost of acquisition or production, which leads to the amortization of such components at acquisition cost not being accepted for tax purposes.

Additionally, this expense is deductible only when effectively supported, i.e. at the time of removal of the antennas and restoring of the site.

**G2) Identification and evaluation of specific fiscal risk**

According to the International Financial Reporting Standard 7 (IFRS 7), the cost of the asset removal is added to the cost of those same assets, and the cost is amortized, so that the risk stems from the fact that taxpayers frequently consider improperly these amortizations for purposes of determining the tax base.

**(NCRF 7, § 17 and D.R. No. 25/09, Art. 2)**

**G3) Response to Assessed Risks - audit procedures**

i. Validate the total depreciation for the year, including amounts depreciated with a constant value in the Income Statement;
ii. Assess whether among depreciations recorded, the point corresponding to the antennas includes an estimate for these expenses;
iii. Should it be included, check whether the respective depreciation amount was increased in the Income Statement, namely that it was not deducted from the tax base.

**H) Special devaluations**

**H1) Knowledge of the business**

Special asset devaluations in telecommunications assets are derived not only from the rapid evolution that occurs in certain types of tangible fixed assets used in the conduct of this activity, such as mobile phones and antennas (mobile communications business), the boxes (pay TV business) and overhead power pylons and wires (fixed communications business) but also from disasters (e.g. fire) or natural phenomena (e.g., strong winds, earthquakes).

Amortizations of assets are accounted for as an expense for the year, corresponding to the net book value of the assets, being fiscally relevant when certain circumstances occur and upon presentation of documents, specifically an affidavit of (i) reduction (devalued assets suffered a tax reduction), (ii) abandonment (in the case of boxes that, taking into account the cost-benefit analysis are left behind in the homes of customers).

**H2) Identification and evaluation of specific fiscal risk**

In the telecommunications sector often times there are special asset depreciations primarily driven by exceptionally rapid technological evolution of those assets. Consequently, there is a risk of not checking all circumstances required by law, so they are deemed as tax expenditures. Such risks may be motivated by (i) the special devaluation has no legal basis (ii) the carrying amount requested is incorrect (iii) failure to produce the required elements, i.e., the minutes, the detailed list of goods and evidence of their net book value).

**(CIRC, Art. No. 38)**

**H3) Response to Assessed Risks - audit procedures**

i. Check the detailed breakdown of the objective elements of special amortization and validate if they contain all the elements required by law, including the description of the goods subject to reduction, year and acquisition value and net book value;
ii. Check the reduction affidavit, abandonment or decommissioning proof of the reason for the special depreciation, accompanied by a detailed breakdown of the assets reduced, and signed by two witnesses;
iii. Select a representative sample of the universe of assets and check the assets subject to sampling, proof of acquisition of those assets (invoice or equivalent document) and the accounting records of their records and accumulated depreciation and validate if:
    - The assets being reduced are recorded as an asset of the company;
    - Depreciation is recorded using the percentage permitted by law to do so;
    - The residual value matches the value indicated by the taxpayer for the purpose of special depreciation.

**4.3 Auditing the Financing Cycle**

**I) Obtaining funds from a non-resident subsidiary**

**I1) Knowledge of the business**

As a result of their large size, economic groups participating in the telecommunications sector have needs for financial means beyond what they can get in the domestic banking market. For this reason, among others, they usually maintain a company in Holland, which has the task of raising funds in the international market (e.g. London) and the subsequent transfer of these funds to Portuguese companies.

**I2) Identification and evaluation of specific fiscal risk**

The funds raised by an international company belonging to the group, which in turn gets them on the foreign market and transfers such funds via a specific remuneration, include the associated risk that these financial transactions do not apply the Principle of Free Competition to the interest rate charged among firms.

**(CIRC, Art. No. 63)**

**I3) Response to Assessed Risks - audit procedures**

i. Specify the funds obtained by every Portuguese company, detailing the interest rate and the term of the transaction and other conditions;
ii. Validate the corresponding funds obtained, as carried out by the subsidiary in the Holland;
iii. Analyze according to the principle of full competition.

**J) The financial burden of holding companies**

**J1) Knowledge of the business**

Holding companies are subject to a tax system based on which they do not contribute to the calculation of taxable income, losses and realized gains on the equity capital and financial burden associated with the acquisition of the capital stock. The Tax and Customs Authority established through administrative doctrine the methodology for estimating the financial costs that do not contribute to taxable income.

**J2) Identification and evaluation of specific fiscal risk**

Meanwhile in the sector organized in an economic group, with holding companies and sub-holdings, telecommunications companies have associated the risk of the tax deductibility of the financial burden for taxpayers to (i) failure to determine the correct amount of financial expenses for not using the financial formula established in administrative rules, (ii) not including all the realities that underlie the concept of financial charges, (iii) the assessment of charges to exclude only in relation to the end of the fiscal year when, taking into account the calculation formula. This calculation should be made by reference at the end of each month.

**(EBF, Art. No. 32 and Circular 7/2004)**

**J3) Response to Assessed Risks - audit procedures**

i. Determine from monthly balances the amounts relating to productive assets (financial loans, cash loans, securities, bank deposits, etc.), and the amounts related to interest-bearing liabilities (bank loans, bonds, commercial papers, etc.) and draw a map with this information;
ii. Determine monthly the amount of interest-bearing liabilities and productive assets:

- If productive assets exceed interest-bearing liabilities, the financial burden to be added to taxable income is not calculated;
- If liabilities exceed interest-bearing assets, the excess will result in the assessment of financial charges not tax deductible;

iii. Determine the remaining amount of interest-bearing liabilities for equity shares - at historical cost - (for the value of any benefits that are considered complementary / subsidiary) as a percentage of total gross assets of the company;

iv. Determine on the basis of monthly financial statements, the amount of financial expenses supported monthly in interest-bearing liabilities (interest, bank guarantees and other), their relative weight of total interest-bearing liabilities, and to this value we apply the ratio calculated in d).

## 5. CONCLUSIONS

The telecommunications industry is characterized by its high degree of concentration of activities in a very small number of companies, by using highly advanced technology and by a business structure formed by economic groups with an international scope.

Given the concentration in this commercial activity, the control strategy used by the Tax and Customs Authority consists of tracking all companies in the sector on an annual basis through the annual review of the risks and recurring audits.

The main fiscal risks of taxpayers in the telecommunications sector involve aspects that characterize companies in the sector, i.e. economic group organization - financial burden of capital management companies - the use of state-of-the-art technology - payments to nonresident businesses for services and royalties, profits from investments in technology, dismantling costs of tangible assets - and the internationalization of the activity - and obtaining funding from non-resident subsidiaries.

As a result of the audits in the telecommunications sector a large number of corrections to the tax income reported by companies have been found.

**Acronyms used**

AT – Tax and Customs Authority
CIRC – Corporate Income Tax Code
CDT – Convention to Eliminate Double Taxation
CDI – Tax Credit for International Double Taxation
EBF – Tax Benefits Statute
IFRIC – International Financial Reporting Interpretations Committee
NCRF – Accounting and Financial Reporting Standard
RFI – Withholding at the International Source
UGC – Large Taxpayers Unit

*Case Study*

*Topic 3.4*

# TAX AND FINANCIAL INTELLIGENCE UNITS AND TAX FRAUD INFORMANTS AWARD PROGRAM

**Flávio Araujo**
General Coordinator of International Relations
Secretariat of Federal Revenues
(Brazil)

***Contents:*** *Presentation. 1. The tax intelligence unit of the Federal Revenue Services of Brazil. 2. Produce knowledge on tax intelligence. 3. Use of human information source. 4. Confidential resources. 5. Legal/policy support. 6. Conclusions and recommendations.*

*Presentation PPT*

This document presents the main aspects on the management of human sources of information and payment of rewards to informants within the Tax Intelligence Unit of the Federal Revenue Secretariat of Brazil (RFB).

It begins with a brief background of tax intelligence in the Brazilian federal tax administration, with emphasis on the development of the Tax intelligence unit in the RFB, founded 17 years ago. It analyzes its main activity, the production of knowledge to support actions to fight fraud and tax and customs illegal activities (including eventually detecting crimes), stressing the importance of the use of human sources of information in this process.

In terms of the management of human sources, it emphasizes on the recruitment of informants, provides intelligence actions which, despite their peculiar sensitivity and complexity, has led to invest in a result-oriented Tax Intelligence Unit at the RFB. It also includes regulatory, legal and conceptual aspects on the payment of informants, as well as the statistics of these activities in recent years.

It concludes on the permanent investment in learning and refinement of the technique, as well as support instruments, recommending this good practice to be evaluated by intelligence units of the tax administrations that have not yet implemented it.

## PRESENTATION

This document presents the main aspects of the management of human sources of information and payment of rewards to informants within the tax intelligence unit of the Federal Revenue Secretariat of Brazil (RFB).

To do this, it contextualizes the tax intelligence activities in Brazil and facilitates concepts for the understanding of the information presented, as well as the legal and statistical data aspects involved.

## 1. THE TAX INTELLIGENCE UNIT OF THE FEDERAL REVENUE SERVICES OF BRAZIL

In the 1970s, the Federal Revenue Secretariat (SRF) began using special control groups, under the supervision of the former Coordination Control system (Cofis), to better fight against tax evasion and evasion of foreign currencies.

At the beginning of 1990, during the Federal Revenue investigation on corruption at the top level of the Government, the need for the institution to have a group of Auditors better technically trained and with better tools to perform complex tax fraud investigation at national levels was detected. Thus, in mid-1993 the special intelligence group was created, composed of selected officers from various units of the institution, under the control and supervision of the General Control Coordination (Cofis).

At the end of 1994 the Tax Intelligence Coordination was created. It initially had in its structure only 2 (two) regional offices, one in the city of Rio de Janeiro (RJ) and the other in São Paulo (SP). During the year 1995, due to the demand of specialized teams in other tax regions, they began to be structured in an informal way, and the regional offices of Recife (PE), Salvador (BA) and Curitiba (PR) were created.

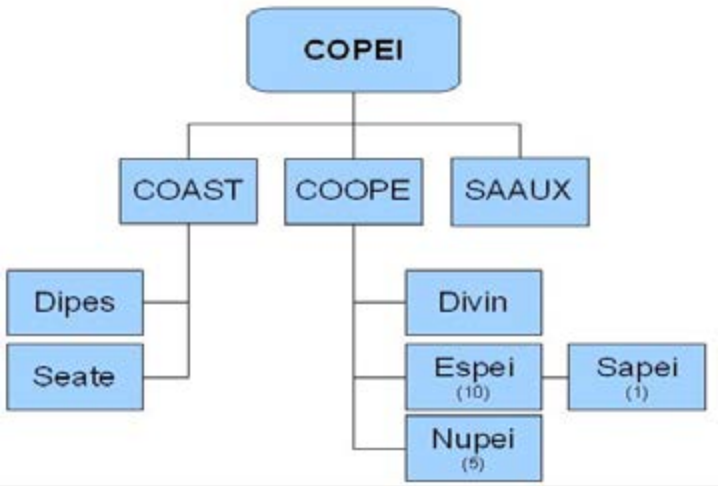
The General coordination of research and investigation of the former Federal Revenue- SRF was initially implemented at the beginning of 1996 with an operational coordination, two divisions and 10 (ten) regional offices. Following the same line, the growing demands showed the need to structuring an area of intelligence capable of acting at the national level. Later, the need for Tax intelligence units in strategic areas of the institution led to the creation, initially through memoranda of understanding, of active research centers and research activity in the cities of Vitória (ES) and Manaus (AM). These centers had this

condition from 1998 to 2001, year in which they were made official along with the creation of two new units: the research and investigation center (Nupei), in the cities of Foz do Iguaçu (PR) and Santos (SP).

The 2007 Changes in legislation, as a result of the creation of the current Federal Revenue Secretariat of Brazil-RFB, contemplate the Copei with four additional units; three of them remain in the present structure: the coordination of Strategic Affairs, the service of Technological Applications and the Research and Investigation center in Campo Grande (MS).

The last regulation change includes the Copei with a special section in the city of Natal (RN). Thus, the overall research and investigation coordination has today the following structure and organizational chart:

| ***Unit*** | ***Quantitative*** |
|---|---|
| General research and investigation Coordination-Copei | 1 |
| Coordination-Coope, Coast | 2 |
| Division-Divin, Dipes | 2 |
| Research and investigation office-Espei (one on each RF) | 10 |
| Research and investigation center -Nupei (Manaus, Campo Grande, Santos, Foz do Iguaçu) | 5 |
| Service-Seate | 1 |
| Special section of research and investigation-Sapei (Christmas) | 1 |
| Section-Saaux | 1 |



Within the RFB framework, the tax intelligence structure has its operation based on:

I. Producing knowledge to assist in the decision making, providing subsidies to the planning, implementation and improvement of the institutions activities;
II. Plan, coordinate and execute actions to fight crimes, fraud and illegal tax and customs activities, laundering and hiding of assets, rights and values and any other offence committed against the federal public administration, or to the detriment of the national treasure, including those that contribute to commit them.
III. Plan, coordinate and execute actions integrated with investigation and criminal prosecution in order to curb the practice of crimes, fraud and breaches enumerated in section (II) of this article;
IV. Represent the institution in systems, organizations, committees, councils and organizations involved in the intelligence activity at all levels of the public administration, in particular those related to the State intelligence, public and financial security aimed at the fight against money-laundering;
V. Propose policies and guidelines related to the institutional security, respecting the competences and initiatives of other areas.

The progressive updating of the tax intelligence structure of the RFB, verified throughout its 17 years of existence, reflects the strategic importance of their activities, not only for the institution, but also for the Brazilian society as a whole, understanding that this structure is essentially required to identify and fight organizations which commit illegalities, that deserve special attention from the Brazilian State.

## 2. PRODUCE KNOWLEDGE ON TAX INTELLIGENCE

The tax intelligence operates primarily in the generation of knowledge to support future actions, including the criminal aspects that are eventually detected. Such intelligence knowledge is generated through a specific methodology, on its own initiative or in response to internal and external demands from other RFB units or other public administrations.

The methodology used for producing knowledge is a regular process of systematic collection and data analysis actions, which result is generalized and materialized through intelligence documents.

The data are any representation of a fact or situation (object), which can be classified into:

a) Available: are freely available for those looking for; and
b) Denied: without access.

Knowledge is understood as any intellectual demonstration appreciated by the agent responsible for its production, which must use all possible information sources, understood as any person, organization or document.

The intelligence actions to obtain the necessary and sufficient data for the production of knowledge in general, are of two types:

a) Collect: consists of the activity, usually open for obtaining available data, i.e. free access for those seeking it
b) Search: consists of an action that is not open for obtaining data that is not available (denied), by the application of personnel, materials and specialized techniques.

Among the more effective actions for producing intelligence knowledge is the use of human sources of information.

## 3. USE OF HUMAN INFORMATION SOURCE

The use of people as a source of information represents an important and probably the most ancient form for intelligence. The exploitation of this work goes back to ancient times, when most of the sources of information available today (electronic media, photos, samples, documentary records, etc.) did not exist.

Throughout history, human sources have proven to be an extremely reliable and effective resource in the process of gathering information. In war times and, in particular, the cold war period, the recruitment of spies within the structure of the enemy was the most used. There are also examples throughout the history of advanced countries, where crimes have been solved with the help of informants.

With the arrival of new technologies, the importance of the use of human sources has been reduced in recent decades, whereas a wealth of instruments such as telephone intercepts, monitoring equipment, telematics, signal, images capturing and communications satellite, etc. provide information.

However, the terrorist events in the last decade, which greatest event was the bombing of the twin towers on September 11, 2001 in New York, highlights the importance given to the use of human sources

worldwide, since all this technology available was not able to prevent this type of event. Reports in the media show this trend:

"The FBI (Federal Bureau of investigations) has recently visited several universities in New England, aiming to find University students, staff and teachers who could become informants for the national police agency. The argument of the FBI for this initiative at the University is the threat presented by terrorists and foreign spies who steal very important research"1

"The FBI with the CIA advise recruit thousands of confidential informants in the United States as part of a broad effort to expand its intelligence capabilities. "(...)" To cope with the increase of the so-called human sources, the FBI also plans to review its database system so it can manage records and verify the accuracy of the information from more than 15,000 informants." 2

In Brazil, the exhaustive use of telephone interceptions by the judicial police, followed by frequent statements in the media exposing the technique has led criminals to become increasingly cautious in their communications, especially in telephone conversations and the exchange of electronic messages. Such situation has progressively reduced the effectiveness of technological media in gathering information, stressing the need to use human sources for intelligence activity.

Today, we can say that human sources of information are as important as it has been throughout the history of intelligence and should be considered as complementary to the operational and technological methodologies and vice versa.

In this context, it should be understood that it is not possible to ignore this valuable resource of tax intelligence in which the RFB has invested for so many years, learning the development and management of human sources techniques, as well as its own doctrine and methodology format.

Human sources of information are a generic term given to any person providing information to a specific intelligence and research agency. It is a genre that includes several species or types, depending on the features or the application of the source.

1 *http://www.wsws.org/pt/2007/jul2007/por2-j03.shtml*
2 *ABC NEWS 25/07/2007*

Classification and terminology for the different species of information sources is not uniform: each organization, in accordance with their doctrine and their needs, defines its own criteria.

Within the RFB tax intelligence, the following human information sources are recognized:

### 3.1. Whistleblower

A whistleblower is any public person who voluntarily report to the Agency about any irregular or illegal act; family, friends, coworkers, or public servants when they have an institutional role do not fall into this category.

The whistleblower may contact the Agency through various means (in person, by telephone, letter, e-mail), anonymously or by identifying themselves.

Anonymous informants generally have little potential since they are not willing to personal contact with the organization officials to achieve a better understanding and use of the information they have. However, there may be cases in which, even they are anonymous, they are willing to maintain future contact with the agency, leaving a phone number, email, or even accepting the possibility of having personal contact.

The identified whistleblower have more potential as a source of intelligence, since in addition for willing to talk with the agency's official, their information tend to be more real, detailed and specific. Although they are identified, it is natural that most of them expect their collaboration to be confidential, a condition that must always be respected by the agency.

### 3.2. Collaborator

It is the individual who collaborates with the agency with information or services, based on mutual trust. This category includes members of the intelligence community, employees of public or private organizations and personal contacts, which can be classified as follow:

#### a) Institutional

They are officers or employees of private companies; although they represent the interests of their institution, they collaborate with an intelligence unit.

**b) Personal contacts**

They are the contacts that information official have, based on their personal relationships, such as friends, family and members of the family.

**c) Organization officers**

They are the officers who work permanently in the organization, but do not belong to the Tax intelligence unit.

### 3.3. Testimonial

This is a source that authorizes their testimony to be used for administrative or judicial proceedings. These sources are classified as testimonials from the moment of that authorization; this does not uncover the confidentiality of their identity at the investigation stage.

### 3.4. Informant

In the course of an intelligence action, there are common situations where the agent, after exhausting all sources of information available, concludes that he could only move forward through the use of a human source that belongs and has access to the organization. In addition to obtaining information, this source may also have the purpose of creating facilities for the organization, such as ensuring the agents access to documents, people, or facilities.

To recruit a source of interest is an action that aims to convince a person who does not belong to the Intelligence Agency to act on its benefit. It is a sensitive process that involves relating with an individual, in order to obtain their cooperation in providing information and (or) services for the organization...

As a general rule, to justify their recruitment, the source should be productive, provide information in quantity and quality, or that it can only be achieved by a careful relationship in time, proximity and reliability. In view of the risks inherent in this process, it is essential that the Agency absolutely control the situation, which is only achieved through a strict control of the source, in order to ensure that it, behaves strictly within the parameters and conditions previously agreed at the beginning of the relationship.

This is how the informant referred as the source which after going through a selection process, runs quietly and under strict control by the

organizations. What differs from other human sources of information is the control that the Organization has on its activities and behavior.

It is important to note that whistleblowers, depending on their characteristics, their access to information and the interests of the Agency, could become informants. To do so, the whistleblower also must go through a selection process that will allow the organization to know and have control; this is one of the main ways by which some tax intelligence agencies build their networks of informants.

### 3.4.1. Payment to informants

There are basically two types of payments that can be made to an informant: refunds and awards (or rewards).

### 3.4.2. Refunds

Refunds are paid amounts to an informant for the reimbursement of the costs of their activity as a source of information, such as compensation, communication tools, housing, food, etc.

If the refunds to an informant are previously agreed, it must be clear in advance what they will really be. The costs not previously agreed should not be compensated and the exceptions can lead to frequent and excessive charges by the informant.

### 3.4.3. Prizes or rewards

Awards, also known as rewards, are amounts paid to an informant for information or services, always according to the results achieved. It is essential to make clear rules and have clear amounts of rewards from the beginning when recruiting the informant, being careful with promises that cannot be kept.

In certain situations, to maintain the motivation of the source to continue acting as an informant, it may be necessary to give a periodically financial reward, regardless of the results, and these awards will be deducted from the final amount of the agreed award.

The RFB tax intelligence unit does not develop specific reward programs to informants that may contribute to the clarification of tax fraud. Each intelligence action that needs the recruitment of an informant is carefully evaluated in terms of their capacity, relevance, feasibility and opportunity

## 4. CONFIDENTIAL RESOURCES

The use of informants can decisively contribute to the success of the tax intelligence actions in fighting crimes, frauds and illegal tax and customs actions and hiding property, rights and values, as well as works that go beyond fiscal interests, in some cases, national security matters. As for example, investigations involving finance of terrorism, one of the world largest concerns on today's agenda of several international organizations such as the UN, the OAS, FATF, etc.

One of these examples is the RFB tax intelligence in the Carbon Operation, jointly performed by the Federal Police and the federal prosecutors, which focused on the embezzlement and smuggling of diamonds, including the so-called "blood diamonds" used to finance guerrillas groups operating in African countries. In addition to these irregularities we found strong evidence of several other crimes: money laundering, tax evasion, currency evasion, conspiracy, corruption, falsification of environmental documents, public documents, among others. In one of the DEA (drug enforcement agency of the United States), the United Nations and Interpol investigation, the participation of foreign citizens involved with international terrorist organizations was found.

The tax intelligence activity strongly fight against organized crime, so it is not recommended that practitioners of criminal acts, especially criminal organizations, be aware of the tools that can be used to unravel their crimes.

Thus, the use of confidential budgetary/financial resources is an instrument that allows safe and successful implementation of tax intelligence measures. This is because the costs are carried out confidentially, from the purchase or rental of specialized equipment to the payment of informants. This can be achieved without the paperwork typically associated with the ordinary processes for using the State agency's resources, even when they are properly monitored and audited by external control organizations.

## 5. LEGAL/POLICY SUPPORT

In Brazil, Presidential decree No. 93.872 of December 23, 1986 sets the unification of resources from the national treasury, updates and consolidates the relevant legislation and establishes other provisions, currently set in the Decree Nº 6.370, on February 01, 2008 (http://www.planalto.gov.br/ccivil_03/_Ato2007-2010/2008/Decreto/D6370.htm) and Decree No. 7.37226 of November 2010 (http://www.planalto.gov.br/ccivil_03/_Ato2007-2010/2010/Decreto/D7372.htm).

Article 45 of Decree 93.872, with the new wording given by the Decree Nº 6.370, specifies that the funds shall be granted to the public officer when the expenses are not subject to the normal process, specifying the following cases:

I – establishing unusual expenses, including travel and special services that require timely payment;

II- when spending should be done in secret according to the classification established in the regulation; and

III -for small expenses, understanding those which amount, in each case, does not exceed the limit set by the Minister of Finance.

In accordance with article 47 of the regulation, the mode “provision of funds” intends to comply with the essential organizations particularities such as the Presidency, the Vice-Presidency of the Republic, the Ministry of finance the Ministry of Health, the Federal Police Department of the Ministry of Justice, the Ministry of Foreign Affairs divisions abroad such as the military and intelligence offices.

The inclusion of the Ministry of Finance and in particular its tax intelligence body, as recipients of this policy, has allowed the implementation of typical tasks of these type of business activities, from this is understood that the expenses for confidential actions are legally authorized as well as the payment of informants.

The regulation, application and granting of funds to cover the costs of a confidential nature, within the framework of the Brazilian federal tax administration tax Intelligence Unit, was held through the Operation rules MF/SRF Nº 01, on March 31, 2005, approved by the Minister of Finance Ordinance No. 70, April 01, 2005.

This rule aims to regulate the granting, application and approval of funds for confidential expenses under the overall of the research and investigation general coordination-Copei and its regional and local units represented by the research and investigation offices-Espei and research and investigation center - Nupei- in particular, they seek:

- To systematically adapt the current legislation for their granting;
- To standardize procedures to facilitate their implementation and certification; and

- To adapt procedures to the particularities of Copei; their Espei and Nupei, do not refer to special expenses.

In terms of disciplinary procedures the Operation Rule MF/SRF Nº 01, March 31, 2005, provides the formalization of the process for each funds granted, which will be maintained in the research and investigation general coordination, available for the competent internal and external control entity, responsible for the Court of accounts of the Union Office.

By having the resources allocated in the annual budget (budget - 001 confidential action) the RFB tax Intelligence Unit is regularly subject to audit by the Federal internal Control Secretariat of the Comptroller General of the Union, which has never received any type of warning by the auditors over the years.

## 6. STATISTICAL DATA

With respect to current expenses in the budget on “confidentiality actions”, it is worth mentioning that the most representative in terms of their execution, are in this order: other services to third parties-legal entities, consumables; and other services to third parties- individuals.

This last category, “Other services from third-party individuals”, focuses on refund payments, either awards (or rewards) to informants made by the RFB tax Intelligence Unit.
As noted above, it has invested over the years in learning the development and management of human sources techniques, as well as in the doctrine and methodology.

This aspect, in addition to the careful measures that must be taken in the implementation of the intelligence action of such nature, justifies the low figures of the following expenses, which represent the payment to informants made by the RFB tax intelligence unit during the past three years.

| TOTAL | | | | | |
|---|---|---|---|---|---|
| 2012 | | 2011 | | 2010 | |
| Value | Quantity | Value | Quantity | Value | Quantity |
| R $ 16.550.00 | 40 | R $ 18.490.00 | 34 | R $ 12.352.00 | 28 |

## 6. CONCLUSIONS AND RECOMMENDATIONS

The RFB today has an extensive administrative, operational structure, data base and technological resources legally focused on taxes and customs, remaining incidental but not less important in the fight against tax crime, customs fraud, corruption and money laundering offences.

From a context in which such illegalities are commonly practiced by large criminal groups, the RFB currently plays an important role in the State's efforts to fight organized crime, the perfect alignment of the institution with the strategy of the Federal Government to invest in creating and optimizing areas of intelligence of various bodies engaged in this mission must be highlighted.

Over 17 years of existence, the RFB tax intelligence unit is continuously refining its doctrine and methodology, including the development and management of human sources of information, which is a complex and sensitive activity, but that entails a high potential for information necessary for the fight against tax and customs crimes.

In this context, despite the few practical cases evidenced in recent years, we can say that satisfactory results have been obtained with the payment of informants. This valuable resource is important to successfully complete the investigations on fraud crimes, tax and customs frauds and crimes and laundering and concealment of assets, rights and values.

Therefore the permanent investment in learning and improving techniques, as well as the regulatory support, is justified recommending for this good practice to be evaluated by intelligence units of the tax administrations that still have not executed them.

*Case Study*

*Topic 3.4*

# TAX AND FINANCIAL INTELLIGENCE UNITS AND TAX FRAUD INFORMANT AWARD PROGRAMS

**Jan-Erik Bäckman**
Tax Director
Head of Research Unit
Tax Agency
(Sweden)

***Contents:*** *Summary. 1. Background. 2. National mobilization – a joint mission from the Government. 3. The structure of the mobilization. 4. Strategic direction and priories. 5. Facts and results in short. 6. Conclusions and experiences so far.*

*Presentation PPT*

## SUMMARY

The presentation is briefly about a national mobilization assigned by the Swedish Government against organized crime. It is a joint venture of several Swedish authorities in combating economic and organized crime. The objective is to disrupt and stop crime, be stronger together and go for the money. The Swedish Tax Agency has a key role in this mobilization and it is an important part of our compliance strategy.

In short the mobilization includes measures to establish task forces and Intelligence Centre in the country and assure a broad representation from all cooperating authorities. It further includes joint developed risk and threat assessment tools and joint prioritization on a strategic and operational level and finally that the resource will be available when required.

It is a long term work and experiences so far are good. Together we are stronger but there are also obstacles and challenges ahead.

## 1. BACKGROUND

For many years the Swedish Tax Agency (STA) has combat tax fraud and tax crime. It is a vital part of our compliance strategy. It is important to show compliant taxpayers that those who cheat with taxes and commit crime get caught. It maintains the tax payers confidence in the tax system and the tax authority but also for authorities in common. It is a sign of good government and a well function society.

In 1998 STA were authorised to undertake own crime investigations within the Tax Agency and established the Tax Fraud Investigation Units as a part of the tax administration. These units were organized as a part of the tax regions in the country.

They were only authorised to work with cases assigned from the Prosecutors Office. In many investigations it is cooperation between the Prosecution Office, the Tax Fraud Investigation Unit and the Police.

In a global world we have to communicate quickly and easily – for example cash flow through various kinds of payment and transaction systems - across national borders and between people and organizations. Criminal activities are hidden behind legal transactions and organizations and also more frequently influence ordinary businesses.

This development increases through increased cooperation between criminal organizations. They also user more violent means and their capability to profit on criminal activities increases. Through various projects, criminals act more powerful and quickly. Also tax bodies and their partners need to act more powerful and quickly to catch up to win the struggle against crime!

Our experience is that cooperation between authorities is necessary and crucial in combating crime. In most of the cases we are very successfully in cooperation, but when it comes to allocating resources it often becomes problems. Different authorities prioritize differently and sometimes necessary resources are not available when needed. For example the police have to deal with and allocate resources for different types of crimes, e.g. violence crime, drug crime, traffic in human being and fraud. When it comes to investigations of tax fraud police resources therefore not always are available.

Another problem in this cooperation is the Secrecy act. It is an obstacle to exchange information on a more general basis, e.g. matching different databases to select criminal cases is not ok according to the Secrecy act. But it is ok to exchange information in specific investigation cases.

## 2. NATIONAL MOBILIZATION – A JOINT MISSION FROM THE GOVERNMENT

According to this background the Swedish Government in 2008 decided that there should be a new kind of cooperation between authorities in the struggle against crime. More focus on secure resources and competence. The Government therefore assigned several authorities a joint mission to disrupt and stop organized crime, be stronger by acting together and go for the money. The objective was to combat organized crime and targeting the most severe criminals.

What was new in this cooperation?

- Common direction and planning at the strategic level.
- Assigned resources and competence in each authority and joint agreements on actions.
- Coordinated implementation by all authority tools available.

The most important in this new cooperation is common prioritization of which kind of criminality to target and a common decision of selection of cases for criminal investigations and other measures. The consequence is that the participating authorities own interest is not in focus. E.g. the Tax Agencies assessment of the correct payment of taxes in each case is not in focus. But tax assessment as a useful tool for taking profits from criminals is a vital part in cooperation. The cooperation is also about analysis and intelligence work.

This cooperation gives the Tax Agency access to resources from the police and the prosecutors and also access to advanced intelligence methods. This gives the Tax Agency better tools in its day to day work with tax returns.

The Tax Agency has very effective tools against crime. We can raise taxes and seize bank accounts and property to secure payment.

The following authorities are assigned by the Swedish Government to participate in the national mobilization against organized crime.

- The Swedish Police
- The Swedish Tax Agency
- The Swedish Enforcement Agency
- The Economic Crimes Bureau
- The Prosecutors Office
- The Swedish Customs

- The Swedish Coast Guard
- The Swedish Security Service
- The Swedish Prison and Probation Service
- The Swedish Migration Board
- The County Administrative Board
- The Social Insurance Office

The work would be undertaken jointly in effort against serious organized crime.

## 3. THE STRUCTURE OF THE MOBILIZATION

The mission included measures to:

- Establish task forces at eight local police authorities and at the National Criminal Police
- Establish eight Regional Intelligence Centre (RIC) together with cooperating agencies
- Develop a National Intelligence Centre (NIC) together with cooperating agencies
- Assure a broad representation from all cooperating agencies in the Operating Council (OC) to be able to make conclusive decisions

The Swedish Police was asked to be responsible for all coordination regarding the implementation of the mission. The Government stated clearly that the starting point of the mission would be a jointly developed threat assessment, which should lead to a decision on a common national strategy. The assignment also included to report the results of the special efforts to combat serious organizational crime.

The authority joint effort against serious organized crime came into force on 1 July 2009. The organization now consists of a Cooperative Council and an Operational Council, a secretariat, a National Intelligence Centre (NIC), eight Regional Intelligence Centre (RIC) and eight task forces. This common platform is described below.

### The cooperative council

The Cooperative Council is composed of the commissioners for the agencies. Its main task is to decide on the strategic direction for the authority joint venture. Cooperative Council orders annually from the NIC an authority common risk picture and threat assessment, relating to serious organized crime. Based on this assessment an annual strategic decision is made. The decision determined by the Cooperative Council is governing for activities in the Operating Council. Cooperative

Council meets twice a year by the National Police Commissioner as Chairman and decisions are always in consensus.

**The operational council**

Operational Council is composed of operational managers from the agencies represented on the Cooperative Council. The representatives of the Council has a mandate to its authority or police region take operational decisions, which, inter alia, means that the resource will be available when required. Operational Council has the task of prioritizing and to decide on the use of action groups and other multi-disciplinary resources. Operational Council meets every two weeks with the head of National Criminal Police as chairman and decisions are always in consensus.

**Secretariat of cooperative council and the operational council**

Offices' main task is to plan and prepare cases, make proposals for decisions, monitor Cooperative Council and the Operational Council meetings. In addition, the secretariat is responsible for the follow up and annually compiling a report to the government, regarding the outcome of the agency joint effort against serious organized crime.

**The National Intelligence Centre (NIC)**

NIC consists of the collaborating authorities except from the Prosecutors Office. The Centre has a strategic function for intelligence analysis and an operational function for intelligence coordination.

One of the NIC main tasks is to compile an authority common risk picture and make a threat assessment, which is the basis for strategic direction decisions. They shall also, in collaboration with the RIC, develop methods, clarify what intelligence needs are to be met, and ensure that the information flow between the eight RIC is coordinated. They will also run a systematic inventory on facilitating factors for serious organized crime in order to improve the fight against this crime. NIC has the primary responsibility for a performance report that measures the effect of the joint work on the current case summaries linked to strategic people and their networks.

**Regional Intelligence Centre (RIC)**

The main task for RIC is to carry out interagency intelligence work in the region. RIC should comprise a steering committee with executives

and a group with officers from the collaboration authorities and the Immigration Service. The centers are at eight locations in the country. The composition of groups and meeting frequency are varied, but generally officers work together about three days a week. All proposals for action to be decided on the Operational Council should have been processed by the RIC or NIC.
Task forces.

Task forces work with preliminary investigations, surveillance and intelligence and consist of altogether 200 police employees, spread over the seven police regions and the National Police. The groups consist of managers / leaders, investigators, analysts, registrars and administrators. Task forces composition and size vary. The teams will work nationally and flexible and almost exclusively in action decided by the Operating Council.

## 4. STRATEGIC DIRECTION AND PRIORIES

The strategic direction for the joint venture is criminal individuals and their network with high capacity to use companies for criminal aims, threats and bribes against officials and witnesses, etc. and use violence.

Priorities in summary:

Swedish criminal groups with high capacity to

- build criminal networks and organizations,
- threatening the social systems,
- involving in legal markets and businesses.

Actors and groups were there is a possibility to seize money and property are prioritized.

Focus on international criminal groups (in connection with Sweden) who deal with

- drugs and traffic in human beings
- fraud, corruption, money laundering and other activities that are related to criminal groups presence in the legal economy, have influence or impact in the political or the judicial system

It is important to go for the money. Profits from crime are often about money. To track and take the money from the criminals is therefore crucial in combating crime.

## 5. FACTS AND RESULTS IN SHORT

So far we have done 36 operations since the start in 2009 and the courts have sentenced 136 people to 421 years in prison.

We see that multi criminal groups get more and more engaged in economic crime. They go for the money in the tax system, e.g. they target VAT-refunds or the system of tax deduction and payment refunds for restoring houses.

In Sweden the Tax Agency is authorized to gather information on transactions in bank accounts. We match computer files of the accounts collected with data from certain cases investigated in the national action plan against tax evasion. As a result we identified exchange bureaus run by criminals. A main part of the money from crime disappears without any identified persons finally receiving the money. The transactions are often ordered by a telephone call or a code and leave no tracks. Criminals buy knowledge from specialists on criminal activities or concepts (intermediaries or crime brokers) of how to do advanced crime.

Anyway this data matching is a very useful tool to track and identify criminal actors and their network.

The profits from crime have become a part of legal business and have of course a negative impact on fair competition in ordinary businesses. Criminal activities are more and more frequent in the public sector, e.g. outsourced health care and schools. We have identified several actors in this area.

## 6. CONCLUSIONS AND EXPERIENCES SO FAR

The main conclusions from the struggle against organized crime are:

- Cooperation from all involved authorities is the only way to make progress – together we are stronger
- A clear government sponsorship of such an initiative is absolutely vital

This is a long term work and we make progress every year. But there are also obstacles. One main obstacle is that it is difficult to move from regional to national focus and prioritization.

In summary the following experiences and challenges are listed

Positive:

- A close cooperation between several authorities in both operational actions and intelligence investigations makes us stronger and more successfully.
- Mutual learning between different competences
- Long-term work is not disturbed by the everyday events
- Joint following-up support for method development

Negative:

- Difficulties to move from regional to national focus
- Every decision has to be made by consensus which make the system a bit slow

We also see challenges ahead:

- Develop the exchange of information and intelligence work.
- Get more skilled and high competence in combating crime – investigation staff, prosecutors and staff in the court.

# DAILY SCHEDULE OF ACTIVITIES

**CIAT TECHNICAL CONFERENCE**
**Nairobi, Kenya**
**September 9-12, 2013**

**DAILY SCHEDULE OF ACTIVITIES**

**MAIN TOPIC: "PREVENTION AND CONTROL OF TAX EVASION"**

**Monday, September 9**

09:00 - 10:00 Inaugural Ceremony
- Statement by the CIAT Executive Secretary, Mr. Márcio F. Verdi.
- Statement by the Executive Council President,
- Welcome Statement by the Commissioner General, Kenya Revenue Authority, Mr. John Njiraini.
- Statement by Kenya Cabinet Secretary of Ministry of Finance, Mr. Henry Rotich.

10:00 - 10:30 **Conference Opening Presentation:** African Development Bank, Mr. Gabriel Negatu.

10:30 - 11:00 Official photograph, coffee and integration

**TOPIC 1: TAX AUDITS IN THE DIGITAL AGE**

Moderator: Carlos Sánchez, Director General, Social Security Resources, Federal Administration of Public Revenues, Argentina

11:00 - 11:25 Speaker: Jaco Tempel, Deputy Director Fiscal Affairs, Netherlands Tax and Customs Administration, (25´)

11:25 - 11:50 Speaker: Enrique Sánchez-Blanco, Head of the International Relations Unit, Tax Agency of Spain (25´)

11:50 - 12:10 Commentator: Raul Zambrano, Technical Assistance and Information Technology and Communication Director, CIAT (20´)

12:10 - 12:30 Discussion (20´)

12:30 - 14:00 Lunch

**Subtopic 1.1: Audit of Computer Based Records**

Moderator: Allison Raphael, Ag. Chairman, Inland Revenue Division, Trinidad and Tobago

14:00 - 14:20 Speaker: Flávio Araujo, General Coordinator of International Relations, Secretariat of Federal Revenues, Brazi (20´)

14:20 - 14:40 Speaker: María Elena Barberan, National Head of Large Taxpayers Department, Internal Revenue Service, Ecuador (20´)

14:40 - 14:55 Discussion (15´)

14:55 - 15:15 Coffee & integration

**Subtopic 1.2: Risk Analysis and Audit Software Tools (Data Mining)**

Moderator: Paul Martens, Technical Assistance Advisor, International Monetary Fund

15:15 - 15:35 Speaker: Alejandro Burr, Director, Internal Revenue Service, Chile (20´)

15:35 - 15:55 Speaker: Martine Meunier, Head of the Interregional Tax Audit Directorate, General Directorate of Public Finances, France (20´)

15:55 - 16:15 Speaker: Dino Iliopoulos, National Manager, Large Business Programs, Canada Revenue Agency (20´)

16:15 - 16:35 Discussion (20´)

**Subtopic 1.3: Control of Electronic Commerce**

Moderator: Alice Owuor, Commissioner of Domestic Taxes - Medium and Small Taxpayers(MST), Kenya Revenue Authority.

16:35 - 16:55 Speaker: Giampiero Ianni, Head of International Cooperation Office, Guardia di Finance, Italy (20´)

16:55 - 17:15 Commentator Márcio F. Verdi, Executive Secretary, CIAT (20')

17:15 - 17:30 Discussion (15´)

**Tuesday, September 10**

**TOPIC 2: PRESUMPTIVE TAXATION AND THIRD PARTY INFORMATION SOURCES**

Moderator: Carlos Vargas, General Director, General Directorate of Taxation, Costa Rica

09:00 - 09:20 Speaker: Henry Saka, East Africa Revenue Authorities Representative (20´)

09:20 - 09:40 Speaker: Binod Sinha, Commissioner of Income Tax Coordination & System, Central Board of Direct Taxes, India (20´)

09:40 - 10:00 Speaker: Juana Maribel Sea Paz, Examination Professional I, National Tax Service, Bolivia (20´)

10:00 - 10:20 Discussion (20´)

**Subtopic 2.1: Reporting of Financial Transactions**

Moderator: Heriberto Erik Ariñez Bazan, Executive Chairman, a.i. National Tax Service, Bolivia

10:20 - 10:40 Speaker: Karina Venier, Deputy General Directorate, AFIP, Argentina (20´)

10:40 - 11:00 Speaker: Flávio Araujo, General Coordinator of International Relations, Secretariat of Federal Revenues, Brazil (20´)

11:00 - 11:20 Discussion (20´)

11:20 - 11:40 Coffee & integration

11:40 - 12:10 Presentation on CIAT publications, programs and projects (Raúl Zambrano y Socorro Velazquez)

12:10 - 17:00 Lunch and Afternoon Excursions

**Wednesday, September 11**

**TOPIC 3: TAX AUDITS: MARKET SEGMENT SPECIALIZATION PROGRAMS**

Moderator: Rajul Awasthi, Senior Development Specialist, World Bank Group

09:00 - 09:25 Speaker: Pancrasius Nyaga, Commissioner of DomesticTaxes-Large Taxpayers Office, Kenya Revenue Authority (25´)

09:25 - 09:50 Speaker: Karina Venier, Deputy General Directorate, AFIP, Argentina (25´)

09:50 - 10:15 Speaker: Martine Meunier, Head of the Interregional Tax Audit Directorate, General Directorate of Public Finances, France (25´)

10:15 - 10:40 Discussion (25´)

10:40 - 11:00 Coffee & integration (20´)

**Subtopic 3.1: Audit of the Gas, Petroleum and Oil Sectors**

Moderator: Alan Carter, Senior Tax Economist, International Tax Dialogue

| | | |
|---|---|---|
| 11:00 - 11:25 | Speaker: | María Elena Barberan, National Head of Large Taxpayers Department, Internal Revenue Service, Ecuador (25´) |
| 11:25 - 11:50 | Speaker: | Heriberto Erik Ariñez Bazan, Executive Chairman, a.i., National Tax Service, Bolivia (25´) |
| 11:50 - 12:15 | Speaker: | Fredrik Aksnes, International Director, General Directorate of Taxes, Norway (25´) |
| 12:15 - 12:40 | Discussion (25´) | |
| 12:40 - 14:10 | Lunch | |

**Subtopic 3.2: Audit of the Mining Industry**

| | | |
|---|---|---|
| | Moderator: | Bheki Mthetwa; Team Leader: Audit, South Africa |
| 14:10 - 14:35 | Speaker: | Stephen Wilcox, Resource Tax Administration Specialist, Adam Smith International (25´) |
| 14:35 - 15:00 | Speaker: | Alejandro Burr, Director, Internal Revenue Service, Chile (25´) |
| 15:00 - 15:25 | Speaker: | Jane Stalker, Coordinator, Industry Specialist Services, Canada Revenue Agency (25´) |
| 15:25 - 15: 50 | Discussion (25´) | |
| 15:50 - 16:10 | Coffee & integration (20´) | |

**Subtopic 3.3: Audit of Telecoms**

| | | |
|---|---|---|
| | Moderator: | Carlos Six, General Manager of Tax Administration, Federal Public Service, Finance, Belgium. |
| 16:10 - 16:35 | Speaker: | Joao Morais Canedo, Deputy Director of the Tax Customs Authority, Portugal (25´) |
| 16:35 - 17:00 | Discussion (25´) | |

**Thursday, September 12**

**Sub Topic 3.4: Tax and Financial Intelligence Units and Tax Fraud Informant Award Programs**

Moderator**:** Logan Wort**,** Executive Secretary**,** African Tax Administration.

09:00 - 09:20 Speaker: Flávio Araujo, General Coordinator of International Relations, Secretariat of Federal Revenues, Brazil (20´)

09:20 - 09:40 Speaker: Stefano Gesuelli, Head of the Italian Mission at CIAT (20´)

09:40 - 10:00 Speaker: Jan-Erik Bäckman, Tax Director, Head of Research Unit, Swedish Tax Agency (20´)

10:00 - 10:20 Speaker: Norbert Steilen, Programme Manager Revenue Assurance, World Customs Organization (20´)

10:20 - 10:45 Discussion (25´)

10:45 - 11:05 Coffee and Integration (20´)

11:05 - 11:25 Catherine Baer, Division Chief, IMF Tax Administration Diagnostic Assessment Tool (20´)

**11:25 - 12:30 Panel Discussion:**

Panel Moderator: CIAT
- Litigation procedures and their impact on auditing (to address court proceedings in an appeal; The Legality of “Life-Style” Audits; and, others)
- Taxpayers Rights (in the audit process)
- Specialized Administrative courts (may include “live” or “virtual” process)

Panel Members: Carlos Six, Belgium; Brian McCauley, Canada; Juliet Kamande, Kenya; Egil Martisen, Norway

12:30 - 14:00 Lunch

**Closing Ceremony**

14:00 - 14:10 Event evaluation (10´)

14:10 - 14:40 Final Technical Conference theme considerations – Michael Waweru (30´)

14:40 - 15:10 Other Activities

- Invitation to next General Assembly and Technical Conference
- Words of appreciation to Kenya Revenue Authority

15:10 - 15:25 Closing words by the Executive Council President (15´)

15:25 - 15:45 Coffee Break and Departure

# LIST OF PARTICIPANTS

# CIAT Technical Conference

Nairobi, Kenya
September 9-12, 2013

## LIST OF PARTICIPANTS

**ADAM SMITH INTERNATIONAL**

**Graeme Keay**
Senior Tax and Legal Adviser

**Stephen Wilcox**
Resource Tax Administration Specialist

**ANGOLA**

**Nara Júnior**
Técnica
Proyecto Ejecutivo para la Reforma Tributaria

**Alice Neves**
Directora Nacional de Impuestos
Dirección Nacional de Impuestos

**ARGENTINA**

**María Luisa Carbonell**
Directora de la Dirección de Asuntos Int.
Administración Federal de Ingresos

**Carlos Alberto Sanchez**
Director General
AFIP

**Karina Venier**
Subdirectora General de la Subdirección General
AFIP

**ATAF**

**Frankie Mbuyamba**
Research Manager
ATAF

**Thulani Shongwe**
Multilateral Cooperation
African Tax Administration Forum
Barbados

**Anderson Padmore**
Chief Management Accountant of Our
Inland Revenue Department

**BELGIUM**

**Carlos Six**
General Manager of the Tax Administration
Fps Finance

**BOLIVIA**

**Heriberto Erik Ariñez Bazzan**
Presidente a.i.
Servicio de Impuestos Nacionales

**Juana Maribel Sea Paz**
Profesional I Fiscalizacion
Servicio de Impuestos Nacionales

**BRAZIL**

**Flavio Araujo**
Coordinador-General de Relaciones
Internacionales
Receita Federal de Brasil

**CANADA**

Brian McCauley
Assistant Commissioner
Canada Revenue Agency

**Bruce Snider**
Manager, International Relations
Canada Revenue Agency

**CATA**
Duncan Onduru
Executive Director

**CHILE**

**Alejandro Burr**
Director Subrogante
Servicio de Impuestos Internos

**Maria Bernardita Moraga**
Jefa de Gabinete
Subdirección de Estudios
Servicio de Impuestos Internos

**CIAT**

**Marcio Verdi**
Secretario Ejecutivo
CIAT

**Raúl Zambrano Valencia**
Director de Asistencia Técnica
CIAT

**Maria-Raquel Ayala**
Directora de Capacitación y Formación del Talento
CIAT

**Francisco Beiner**
Director de Operaciones y Gestión Institucional
CIAT

**Socorro Velazquez**
Dir., Planning and Organizational Development
CIAT

**COSTA RICA**

**Carole Quesada**
Subdirectora General de Hacienda
Ministerio de Hacienda

**Carlos Vargas Durán**
Director General
Dirección General de Tributación

**Maribel Zùñiga Cambronero**
Directora de Relaciones Tributarias
Dirección General de Tributación

**CROWN AGENTS**

**Michael Canvin**
Director, Tax
Crown Agents

**ECUADOR**

**Martiza Malena Barberán Benavides**
Jefe Nacional del Área de Grandes Contribuyentes
Servicio de Rentas Internas

**EL SALVADOR**

**Yoni Adalberto Girón Escobar**
Jefe División Jurídica
Dirección General Impuestos Internos

**Jose Ernesto Morales Olmedo**
Coordinador de Grupos de Fiscalización
DGII

**ETHIOPIA**

**Guled Abdo**
LII

**Desta Bezabh**
LII
Zeymi Jemon
LII

**FRANCE**

**Martine Meunier**
Head of the Interregional Tax Audit Directorate
DGFIP

**Isabelle Gaetan**
Head of Mision
DGFIP

**GIZ**

**R. Alexis Nzitonda**
Advisor on Tax Harmonization in East African Commu

**GUATEMALA**

**Gladis Gil**
Directora Suplente
Superintendencia de Administración Tributaria

**Ariel Guerra**
Intendente de Fiscalización
Superintendencia de Administración Tributaria

**Carlos Muñoz**
Superintendente
Superintendencia de Administración Tributaria

**Edgar Alfredo Pape Yalibat**
Director Suplente
Superintendencia de Administración Tributaria

**HAITI**

**Jean-Baptiste Clarck Neptune**
Directeur General
Direction Generale des Impots

**INTERNATIONAL MONETARY FUND (IMF)**

**Paul Martens**
Technical Assistance Advisor
International Monetary Fund

**INDIA**

**Sudha Sharma**
Chairperson
Central Board of Direct Taxes

**Binod Sinha**
Commissioner of Income Tax Coordination & Systems
Central Board of Direct Taxes

**ITALY**

**Giampiero Ianni**
Head of International Cooperation Office
Guardia di Finanza

**Stefano Gesuelli**
Head of the Italian Mission at Ciat
Guardia di Finanza

**ITC**

**Heidi Wagner**
Advisor

**Alan Carter**
Senior Tax Economist

**KENYA**

**John Njiraini**
Commissioner General
Kenya Revenue Authority

**Lucy Njoe**
Senior Assistant Comm
Kenya Revenue Authority

**Pancrasius Nyaga**
Commissoner Doemstic Taxes
Kenya Revenue Authority

**Emmah Omwenga**
Assistant Comm.
Kenya Revenue Authority

**Kennedy Onyonyi**
Senior Deputy Commissioner in Charge of Marketing

**Alice Owuor**
Commissioner of Domestic Taxes - Medium and Small

**LESOTHO**

**Thabo Letjama**
Commissioner General
Lesotho Revenue Authority

**Realeboha Mathaba**
Commissioner
Lesotho Revenue Authority

**MALAWI**

**Henry Ngutwa**
Director of Investigations
Malawi Revenue Authority

**MALAYSIA**

**Abdul Hamid Hashim**
Principal Assistant Director
Inland Revenue Board of Malaysia

**Syed Hisham Syed Mansor**
Director
Inland Revenue Board of Malaysia

**NETHERLANDS**

**Jaco Tempel**
Deputy Director Fiscal Affairs
Netherlands Tax and Customs Administration

**NICARAGUA**

**Sayda Jenniffer Dávila García**
Jefe de Programación y Control de Fiscalización
Dirección General de Ingresos

**NORWAY**

**Fredrik Aksnes**
Head of Department
Norwegian Tax Adiministration

**Egil Martinsen**
International Director
Norwegian Tax Administration

**PERÚ**

**Enrique Vejarano**
Superintendente Nacional Adjunto de Tributos
SUNAT

**PORTUGAL**

**Jose Antonio Azevedo Pereira**
Diretor-geral
Autoridade Tributaria E Aduaneira

**João Canedo**
Subdiretor-gera
Autoridade Tributária E Aduaneira
Unidade Dos Grandes Contribuintes

**Maria Angelina Silva**
Subdiretora-geral
Autoridade Tributária E Aduaneira

**SEYCHELLES**

**Gayathri Andre**
Manager Large Audit
Seychelles Revenue Commission

**Elma Athanase**
Compliance Program and Policy Analyst
Seychelles Revenue Commission

**SINT MAARTEN**

**Guilliano Saturnilia**
Head Audit and Criminal Investigation
Tax Administration Sint Maarten

**SOUTH AFRICA**

**Bethuel Bhekokwakhe Mtetwa**
Team Leader
South African Revenue Service

**Itumeleng Phogojane**
Operational Specialist
SARS

**SOUTH SUDAN**

**Joseph Kenyi Mumo**
LII
South Sudan

**SPAIN**

**Luis Cremades**
Jefe de la Misión Española
AEAT España

**Enrique Sánchez-Blanco Codorniu**
Jefe Unidad de Relaciones Internacionales
Agencia Tributaria de España AEAT

**Special Guest**
Michael Gitau Waweru
Former Commissioner General
Kenya Revenue Authority

**SWEDEN**

**Jan-Erik BackmanTax**
Director, Head of Research Unit
Swedish Tax Agency

**Lars Ake Leijkvist**
Head of Management Staff
Swedish Tax Agency

**TANZANIA**

**Rished Bade**
Deputy Commissioner General
Tanzania Revenue Authority

**Lucas Mwessy Kaigarula**
Manager Audit
Tanzania

**Felix Lema**
Tax Officer
Tanzania Revenue Authority

**Lusekelo Muraseba**
Commissioner For Tax Investigation
Tanzania

**Ramadhan Idd Muya**
Manager Audit
Tanzania

**TRINIDAD & TOBAGO**

**Mary Allison Raphael**
Ag. Chairman
Inland Revenue Division

**Phyllis Siew**
Asst. Commissioner
Board of Inland Revenue

**URUGUAY**

**Alejandro Grilli**
Director de Área
DGI

**WCOOMD**

**Steilen Norbert**
Technical Officer
World Customs Organization

**WORLD BANK**

**Rajul Awasthi**
Senior Specialist
Investment Climate Department, IFC

**Moses Kajubi**
Senior Operations Officer Business Taxation
World Bank Group

**ZAMBIA**

**George C. Siame**
LII
Berlin Msiska
LII

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