

Examination Handbook

Strengthening the Examination Function in the Tax
Administrations of Latin America and the Caribbean

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the Tax Administrations of Latin America and
the Caribbean

Inter-American Center of Tax Administrations



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FOREWORD

This manual is about the examination function as exercised by Tax Administrations. Emphasis has been placed on describing the process of risk management and on describing the aids to carrying out this process. Attention has also been paid to elements of the examination function in special situations and to the recruitment, selection and training of new employees with examination tasks.

I am pleased with the manual because enforcement starts as early as when thinking up and writing down new tax laws and not simply when assessing tax declarations. This approach to enforcement is properly expressed in the manual. It is important to bear in mind here that the position of the Tax Administration in the Netherlands with respect to the politically responsible minister is the same as that of the department for fiscal, legislative policy. This position provides us with the possibility of exerting influence on the contents of legislative texts even as they are being written. After all, laws need to be both feasible and enforceable. Moreover, avoiding enforcement problems when writing laws means that no (expensive) enforcement efforts have to be carried out later.

The manual is also the product of efficient international cooperation. The employees of a number of Tax Administrations, affiliated with the CIAT, from Latin America, North America and Western Europe jointly discussed and determined the themes and contents of the manual during labour-intensive sessions, whilst keeping to the guidelines formulated by the CIAT when they issued the assignment.

The Netherlands is proud to have been able to guide yet another CIAT project, up to and including the publication of the manual. I was happy to give the request my seal of approval and am pleased that we now see before us the book that is the tangible result of all those efforts.

Finally, I would like to express the hope that during the next few years this manual will serve as a source of inspiration and a guide for the further development of the examination function of Tax Administrations.

Jenny Thunnissen
Director-General of the Netherlands Tax and Customs Administration

FOREWORD CIAT

Although the tax agency handles a variety of responsibilities, examination is the most complex, existing for the main purpose of monitoring the taxpayers' full and timely compliance with their obligations, whether material or formal.

Examination actually plays a key role in the effectiveness of the agency, and is a fundamental instrument in fighting tax evasion by ensuring fair application of the tax system, providing an adequate level of tax revenues and encouraging spontaneous compliance with the tax obligations.

In order to effectively assist in the promotion of spontaneous compliance with tax obligations, the strategies of the most advanced government agencies are based on a number of measures implemented to facilitate compliance for the taxpayers, while also conveying to these taxpayers the idea that a breach of their tax obligations involves a certain degree of risk, since there is a high probability of audit and penalties. Rather than offering an impression of impunity, this risk is a strong incentive for spontaneous and timely compliance with the tax obligations.

Proper performance of the examination function depends on whether the following key aspects (among others) for this task can be achieved:

- professionalism of the tax agents, in terms of high levels of technical capacity and a sense of ethics and service, thereby projecting an image to society of a fair, efficient and effective tax agency;
- transparency and appropriateness of the standards and procedures that are to be implemented; so that taxpayers know what to expect from their efforts, while also providing the Tax Administration with sufficient authority to take action and to access tax-related information; and
- implementation and utilization of information systems and modern technology, enabling objective criteria to be applied when scheduling and carrying out examination tasks, while also allowing the progress of every step of the process to be monitored.

Once these aspects are attained, the examination objectives become easier to accomplish because the above characteristics will allow the agency to:

- first, foster both an attitude of respect toward the tax agency and greater acceptance of taxes by the citizens;

- second, provide an assurance of fairness since all taxpayers will be treated justly, based on objective assessments of their conduct, avoiding discretionary approaches that could lead to arbitrary procedures; and
- third, establish effective control of the tax obligations, by identifying non-compliance with regard to the various gaps traditionally observed, such as the gap that exists when taxpayers have not registered with the tax agency, the gap of registered taxpayers who do not file their returns, the gap of taxpayers with tax returns that are inaccurate, insufficient or fraudulent, and the gap of taxpayers who file correctly but do not pay.

Despite its extreme importance, in many countries the field of examination is poorly developed compared to the advances achieved in other functions, which is essentially due to the shortage of resources and/or the lack of an adequate strategy, as well as to its inherent complexity. Even in countries where major strides in the examination function have been made, the changes that have occurred in the current economic and technological climate in which the tax agencies are working have created new challenges and new opportunities that are well worth analysing.

All of the above simply underscores the importance of this CIAT Examination Manual, as it results from the thoughts and experiences of highly qualified tax agents involved in tax enforcement, making it an essential handbook that will enhance the examination function in all of our member countries.

Furthermore, the scope of the issues addressed in this manual cover virtually every aspect within the field of examination, from the initial analysis for defining control policies and strategies to the organizational aspects, human resources, new tax inspection-related challenges and audit techniques.

Lastly, I would like to express appreciation to all the member countries which, under the coordination of the executive secretary's office of the CIAT, have collaborated in the efforts involved in this endeavour, with the participation of high-level and well-qualified tax agents specializing in enforcement at their respective agencies: Argentina, Brazil, Canada, Chile, Spain, the United States, France and, in particular, the Netherlands which, in keeping with its customary generosity, has assumed both the sponsorship and the management of the working group and has provided

ongoing support to the development of each stage through a fine group of tax agents at its own tax agency.

Jorge Cosulich
Executive Secretary, CIAT

JUSTIFICATION

This manual is the result of intensive international cooperation between the representatives of Tax Administrations from Latin America, North America and Western Europe. The project was under Dutch chairmanship. The invitation to chair was regarded as a special honour and was eagerly accepted. The manual could not have been brought about without the close involvement and intense participation of all those who took part in the project.

Two working groups were active in the project, the Dutch writers' group and the international working group. Employees of the Dutch Tax Administration wrote draft chapters according to the guidelines formulated by the CIAT in issuing the assignment. These drafts were discussed intensively during four sessions in an international working group comprising representatives from eight CIAT countries, the Dutch writers' group and the CIAT itself. The Dutch working group incorporated the results of these inspiring discussions into the final versions of the chapters. As a result the manual contains models, procedures and techniques that reflect broadly accepted outlooks and insights.

The aim of the manual is to provide Tax Administrations with points of departure for their further development. The starting point for every change will be that a Tax Administration asks itself: "What is our position and where are we going?" The analysis model in Chapter 1 serves as a foundation. The model visualizes the relevant circumstances and the interdependencies that affect the current position of the organization. The model can be used to obtain insight into possibilities for altering aspects of the model and any results this may have. The model also shows that there are large cultural, organizational, statutory and other differences between the Tax Administrations. As a result, no single blueprint can be provided on how Tax Administrations should organize and implement the enforcement function. Where possible, the international working group has tried to include good model solutions for a number of topics. These are topics about which the members of the international working group feel that the proposed method of working is efficient and worthy of recommendation. The manual contains several references to such good practices.

We cannot emphasize enough that throughout the world there is one important condition for achieving effective enforcement that paves the way for all other conditions, that is, an integral implementing organization. The adequate remuneration of employees and banishing clientism and

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privileges are necessary conditions for the integrity of an organization. The tasks and activities of Tax Administrations should stem from legislation and not be subject to political influence.

Increasing globalization and internationalization make it necessary to look beyond one's borders. Increasingly, Tax Administrations will have to cooperate in order to cope with the developments in society. One cannot overemphasize that countries will have to enter into tax conventions in order to facilitate international cooperation and the exchange of information. At a national level, calling upon financial institutions in carrying out collection is an important step on the way to becoming a professional organization. For this reason, proper agreements will have to be made with the banks.

During discussions on the various sections of the manual in the international working group, one of the obstacles was that each country has its own ideas on the meaning of concepts such as examination, validation, verification and audit. In each country these concepts can only be understood within the context of that country. A proper understanding of this manual requires a knowledge of the definitions of the aforementioned concepts as defined by the international working group. In other words, when reading the manual it is important to bear in mind that in this manual seemingly familiar concepts are only used in the sense they have been specifically given. This means that in a number of cases the reader will have to translate to the situation of his own organization. Further attention to this matter is paid in the Introduction.

I would like to express my thanks to all those who participated in the Dutch writers' group and Cees van Vliet, who acted as chairman right from the beginning, for their enthusiasm and the professional way in which they have contributed to the realization of this manual. Along with the writers' group, I also would like to thank everyone who provided them with information and critical comments or in any other way contributed to the realization of this manual.

I am also greatly indebted to the international working group, which provided positive critical comments on the Dutch texts in a healthy working atmosphere. Thanks to those comments it has been possible to develop this manual from a good Dutch product into a good and thorough international product. We really did work on it together. And no matter how critically we took one another to task during the working sessions, it never formed an obstacle to pleasurable companionship during the evenings. Of course, we

are also indebted to the CIAT, which came up with the idea to produce this manual. I would like to thank the CIAT by way of two representatives: the Executive Secretary, Jorge Cosulich Ayala, and the Director of Programming and Studies, Claudino Pita, whose extensive knowledge helped make this project a success.

In this respect I also need to express my gratitude to Matthijs Alink, the representative of the Dutch Tax and Customs Administration for the CIAT, who adopted the idea of this project and who, as the responsible principal for the implementation of the project to get the manual actually written, invited me to participate and chair the working group in the final stage.

Finally, I would like to thank Jenny Thunnissen who, in her position as Director-General of the Dutch Tax Administration, put her faith in us and made the realization of this project possible.

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INTRODUCTION

This manual is about the examination function of Tax Administrations. A number of conditions need to be fulfilled if Tax Administrations are to function professionally. For example, Tax Administrations need to be able to carry out their work independently of political influence, employees must receive sufficient remuneration and the integrity of the Administration and its employees must be guaranteed. The actions of Tax Administrations must be transparent, predictable and such that citizens are able to check their performance. By way of an example (and many others could have been chosen), we shall pay closer attention to the description of the French Tax Administration's mission statement.

The mission statement of the French Tax Administration (FTA) is based on Article 13 of the Declaration of the rights of man and citizens dated 26 August 1789: "A common contribution is essential for the maintenance of the public force and administration expenses: it must also be equally distributed among the citizens, according to their capacity." The FTA should therefore contribute, within the limits of its domain of intervention, to a better acceptance of tax and a fair system of financing public charges. Within said framework, it endeavours to promote, under all circumstances, the highest level of fiscal community spirit, that is, the voluntary compliance of taxpayers with their tax obligations. Such a purpose should be applied to each of the activities of the FTA.

- The Tax Administration should strengthen the contents and quality of the services it provides to users in order to facilitate its task. Such an improvement in services would, in particular, undergo the highly significant use of new information and communication technologies as a complement to the services already being provided by the FTA. The quality of contact in its various forms would be reinforced, especially through the implementation of quality standards. This procedure would contribute to making the FTA into a service administration located at the centre of public service.
- The Tax Administration should try to promote the understanding of fiscal rules and the acceptance of tax according to the rules it establishes and the procedures it uses. Simultaneously, it should increase its response in fighting fiscal fraud and strengthening the quality of its control operations. Supported by its agents and staff, motivated and dedicated to rendering a quality service, the FTA should modernize the management of its human resources and seek support for organizing and reducing working hours in order to contribute to ensuring that everyone benefits from the social advances that permit the improved organization of work. It should also reinforce the qualifications of staff, train them in

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new technologies, and continue efforts to ease management tasks, providing them with applications and computer instruments for working within a renewed working framework. In accordance with these strategic options, the FTA should provide a better public service at lower costs.

All these projects should be examined with respect to:

- the advantages to users, who should benefit from improved services;
- the advantages to the agents, who are not only the beneficiaries, but also the actors, in modernizing the FTA; and
- the advantages to all taxpayers, who will benefit from the productivity gains achieved by the FTA in administering its costs.

On a general note, it is important to realize that the examination function covers both expensive and less expensive activities. Validation and verification are extremely cheap in comparison with auditing. It is therefore recommended that examination processes are organized such that validation is the only form of examination for the majority of tax returns, verification for a smaller proportion and that audit activities only need to be carried out for a limited proportion of tax returns.

As announced in the Justification, this manual makes use of terms which are familiar to all the Tax Administrations, but which are often given a slightly different interpretation. Therefore, it would seem fitting to define here a number of essential terms. Not with the idea of obliging the reader to use these terms in exactly the same way in his own country, but to explain what is meant when these terms are used in this manual.

Enforcement: All activities that involve the promotion of compliance with tax laws, varying from influencing legislation, via services to citizens and all examination activities to, finally, criminal prosecution.

Examination: validation, verification and auditing.

Validation: The process of validation comprises all activities that contain the following elements. It must be a case of an initial review with 100% coverage, involving mass processing without any interpretation, but rather data matching and calculations to discover any inconsistencies in the tax return. There is no interaction with the taxpayer. The result of validation may be that the tax return is found in order or that the tax return needs further treatment (verification or audit).

Verification: The process of verification comprises all activities that fulfil the following descriptions: documentary review, office examination, desk

review or desk audit. Internal information is used in the verification process and contact with the taxpayer is usually (but not exclusively) by telephone, letter or e-mail. The result of verification may be that the tax return is found in order, that adjustments have to be made, or that the tax return needs further treatment (audit).

Audit: The process of auditing comprises all activities that fulfil the following description: examination, external control, field audit and accounting audit. The audit is usually performed at the taxpayer's premises. The result of the audit may be that the tax return is found in order or that adjustments need to be made.

Large, medium and small enterprises: Many Tax Administrations apply criteria for dividing the businesses on their files into large, normal and small businesses. The criteria applied are linked to the size of the economic activities in a country. In a number of cases, one reverts back to the criteria that apply to, for example, the duty of legal entities to publish. In other words: there is no single uniform criterion.

CHAPTER 1

THE ANALYTICAL MODEL

1.0. Summary

In Chapter 1 an analytical model is introduced. The model describes the need for a mission to establish a Tax Administration, and discusses the relevant context factors, their relation with the treatment strategy and the possibility to use tools to improve the functioning of the administration. The model is dynamic and all aspects are interdependent. With the model one can determine the circumstances that will be influenced in the long run and the possibility of change in the short run.

1.1. Introduction

Taxes have been around since the beginning of time. However, over the centuries production processes have grown increasingly complex and services have become the mainstay of many economies. Since the cornerstone sustaining the economies has shifted from agriculture to industry and services, and the nation states are developing through trends such as globalization, computerization and internationalization, the current demands placed on the Tax Administration with regard to monitoring are different from those of the past. As the bases for tax legislation become more abstract, the demands regarding enforcement are growing increasingly burdensome. Tax imposition and collection are not the only tasks: there are also compliance promotion through stricter control, an increased effort to organize validation, the verification and (tax)auditing policy, as well as the effort to increase and improve the taxpayers services and assistance. In this regard, the Tax Administration is assuming an increasingly active role in the area of tax enforcement with the aim not only to establish a level playing field between the taxpayers (or economic contenders) but also to ensure that the revenue objectives of the state are met.¹ As a result, the Tax Administrations are required to devote additional resources to organizing an inspection and audit policy.

1. It is up to the parliament/legislation to define the types and quantum of taxes to be collected, and up to the Tax Administration to ensure that the words and spirit of the tax is respected.

This handbook discusses the relevant aspects of the verification and auditing policy. Chapter 1 describes an analytical mode that outlines the interrelationships and mutual influences of all aspects of the relevant environment (the context), the treatment strategies selected, the tools and the objectives. In addition, the model governs the structure of the book.

1.2. The place of the validation, verification and auditing policy within the Tax Administration

1.2.1. The analytical model

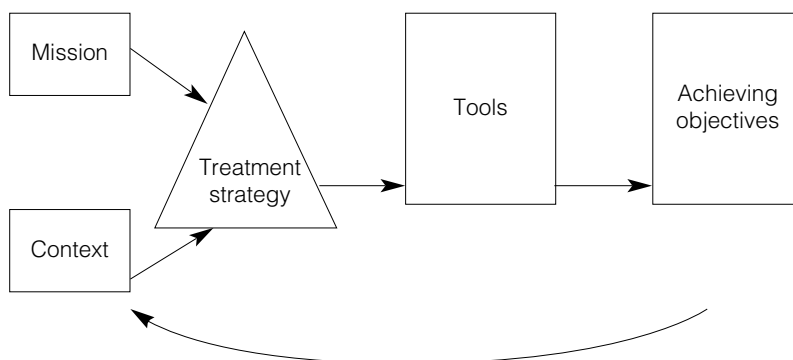
The Handbook for Tax Administrations – Organizational Structure and Management of Tax Administration² provides a large number of examples of the mission statements of Tax Administrations (pp. 22-25). While the legal mandate of a Tax Administration is defined by legislation, its vision on how to deliver such a mandate, including its core values, is reflected in its mission statement. In some countries the emphasis is on providing service to the citizens, whereas in other countries the effectiveness and efficiency of the Tax Administration are the primary objective and, in others again, the levying and collecting of taxes are the dominant elements in the mission statement. The verification and auditing policy is closely related to the chosen mission.

Figure 1 visualizes the interrelationships between the relevant aspects by formulating the enforcement policy. In Appendix 1 a comprehensive version of the model is included. The relevant circumstances in a country, i.e. the context, are the starting point. Elements of this context include the legislation, culture, structure and characteristics of the Tax Administration, trends and developments, human resources management (HRM) and factors in the environment. By legislation is meant the legal context in which the levying of taxes should be realized, and includes both the laws for the levying as such (what is the base of the levy?) and the laws in which the rights and obligations of the taxpayer and the Tax Administration are laid down. The culture of a country is a constant fact and determines whether, within the enforcement policy, the emphasis is on voluntary compliance, or rather on verification and auditing. Trends and developments include such phenomena as globalization, internationalization and digitization of economic activity. HRM includes aspects such as the available manage-

2. CIAT publication 2000.

ment capacity, the level of training and education of employees (the conditions for recruitment) and, for instance, the integrity of civil servants. Examples of environmental factors are non-fiscal issues that may affect the enforcement policy and include the size of the territory of a country in relation to the size of its Tax Administration, the nature of the economy, the political regime and the relationship between the government and its citizens (including the extent of social programmes, etc.) as well as habits and customs, etc.

Figure 1: The analytical model



Context and mission determine the desired *treatment strategy*. This treatment strategy is always represented as a pyramid and is referred to as the enforcement pyramid. In this pyramid, services to the public and activities aimed at prevention are located at the base. These activities are intended for the entire population of taxpayers and are characterized by a limited number of activities per taxpayer and by the indirect nature of the contact with the taxpayers. It is also based on the belief that the majority of taxpayers will comply with limited enforcement, given that the required information and infrastructure are easily accessible. Nevertheless, it is recognized that, in order to provide a level playing field, some taxpayers will need closer attention. The higher up in the pyramid, the smaller the group of taxpayers becomes, enforcement becomes increasingly extensive, more profound, more directly targeted and more labour-intensive. The most intensive form of enforcement, i.e. criminal prosecution for fraud, is at the top of the pyramid.

Tools are used to achieve the formulated objectives, given the context and the treatment strategy selected. Tools are deployed to tackle and eliminate

any shortcomings identified. Examples of tools are: the planning cycle and budgeting, structuring processes, training and education, organizational development and, finally, the verification and auditing methods and techniques.

The model in Figure 1 illustrates that the context determines the optimal treatment strategy. To the extent in which the Tax Administration controls matters, tools provide support, achieving objectives within the existing context and applying the treatment strategy selected. In this sense, the model can also be used as an analytical tool to find out which actions are required to achieve objectives.

1.2.2. Limitations of the handbook

This handbook is explicitly limited to the verification and auditing policy of Tax Administrations and does not enter into any aspects of fraud and criminal behaviour identified through government enforcement and subsequent prosecution. The treatment of criminal aspects within the context of the fiscal enforcement policy is an important function, which should be the subject of a separate handbook. That book should cover subjects such as: a stringent separation between administrative enforcement and criminal prosecution, both important for respecting the rights of the taxpayer, the change in atmosphere, the sanctions and fines policy, and the issue of finding the fiscal truth versus the right to remain silent. These subjects cannot be properly covered in the margin of a treatment on the verification and auditing policy.

The handbook is also restricted to the enforcement of tax legislations and thus does not extend to enforcement by the Customs Administration. Though the Customs Administration is frequently part of the organization of the Tax Administration, the nature of its enforcement activities differs. Thus, a description of law enforcement by Customs Administrations would equally benefit from a separate handbook.

1.2.3. The implementation programme of new legislation

Taxes are levied under the law. A prerequisite for implementing the law correctly is that the legislation is feasible and enforceable. In order to prevent problems later on with regard to verification and auditing, it is rec-

ommended, within the scope given by the juridical frame of each country, to incorporate a so-called “implementation programme”. This programme tests the design against the components of what constitutes good legislation, calculates “compliance costs” (for taxpayers) and “administrative costs” (for the Tax Administration) as usually referred to in tax literature, and clearly defines the implementation costs and strategy, including the feasibility test. A correct, timely and complete introduction should not only be ensured in the drafting and enactment of laws and regulations, but also in the implementation process.

Periodically, an evaluation of the provisions in the law and other comparable initiatives should be carried out so that the legislator can see whether the desired effects of the laws and regulations are (still) achieved.

In the Netherlands, the implementation programme consists of the following stages:

- assessing the feasibility and enforceability of the legislation;
- calculating the implementation costs (incidental and structural);
- establishing the strategy of implementation within the organization;
- enforcing the new legislation unambiguously; and
- evaluating the new legislation (after some years).

The question with regard to the need or type of tax legislation is a political decision and not a question to be answered by the implementation programme.

The enactment process of new legislation comprises the following roles and/or actors:

- a legislative role: new and amended legislation is created after initiatives by the political body of the civil service, for instance following experiences with the implementation of legislation. Drafting (new) law texts may have been delegated to a special department;
- an organizational advisory role: this role includes a number of aspects. Advice is given on the feasibility, the enforceability and the costs of the legislation. *Advice on feasibility* concerns fiscal aspects of a technical nature, consequences for the organizational structure of the Tax Administration as well as for the planning of its operations, consequences for computerization, any effect upon obligations and their costs for the taxpayer, any effects on non-fiscal revenue, and information for the taxpayer. *Advice on enforceability* of new legislation deals with its acceptance by society, recognizability (simplicity and clarity, see example at the end), the scope of regulations, sensitivity to misuse

and abuse, and possibilities for control and sanctions. *Advice on the costs of implementation* refers to the necessity to claim additional budgets if the new legislation results in additional duties or activities of the Tax Administration. These costs involve additional employees, modification or extension of computer equipment and software, costs of information and education material, etc. In calculating these costs a distinction should be made between exceptional (one-time implementation) and structural (ongoing) costs;

- a fiscal advisory role: it is recommended to test new legislation from a fiscal point of view for its politically sensitive and tax-policy aspects;
- implementation role: tax officers and the public must be informed that new legislation is coming into force, on which date it is effective, and also in which way the new legislation must be applied and enforced. To this end, new legislation must be incorporated into training and information material; and
- monitoring progress: the progress of the legislative process and its subsequent implementation, and actual outcomes and results must be monitored.

Depending upon the way in which a country has regulated enforcement, non-fiscal bodies will also be involved in the legislative process. Checking the calculation of implementation costs, granting any budgetary claims, managing the allocated resources, and estimating the implications for the tax revenue may be delegated to one or more departments, but the activities must be coordinated.

Recognizability of legislation

In the Netherlands, the law has charged the Tax Administration with carrying out the implementation programme. New legislation is tested for the following concrete elements of recognizability, simplicity and clarity:

- appropriately and clearly defined target groups;
- the use of unambiguous and lucid concepts and definitions;
- the use of clear criteria;
- the use of fixed arrangements, valuation rules, fixed rates and amounts;
- avoidance of superfluous and difficult to apply thresholds and limits, or of complicated computations;
- keeping the number of exceptions to the rule to a minimum; and
- minimizing options from which the taxpayer is allowed to choose.

1.3. The context

In order to be able to apply the analytical model, it is necessary to have a clear picture of the relevant circumstances and conditions: the context. In every country, the circumstances will be weighed differently. Though the description of the context factors in this document is not meant to be exhaustive, it does cover the most important circumstances and conditions.

1.3.1. Legislation

The legislation encompasses both the basis of taxation and the rights and obligations of the taxpayers and the Tax Administration. This handbook describes details of both aspects of the law. Obviously, other laws of the land will also have an impact, for instance a charter of citizen's rights, the criminal code, laws for financial transactions, or other organizations of the government.

Acts are first of all unalterable facts, but can, nevertheless, be influenced by the Tax Administration. The degree in which this influence can be exercised depends upon the position of a legislative department within the structure of the government and the relationship with other actors in the legislative process. For example, the level of segregation/integration between the Tax Administration (Revenue Department) and the fiscal policy maker (Finance Department).

1.3.1.1. Laws providing the basis for taxation

At least tax laws describe on whom tax can be levied (the subject), on what it can be levied (the object), and when it should take place. They include provisions on the way in which the tax liability should be calculated. The basis, the object and the subject of taxation have a direct impact on the way the enforcement process is set up. If the subject is the final link in the business chain (for example, a sales tax at the retail level), this will involve a large number of taxpayers, including numerous small and medium-sized businesses. On the other hand, a tax at manufacturer level will have a more limited taxpayer base and is often more stable due to the requirement for investments in production equipment. This will have an influence on the treatment strategy to be selected, but also on the relationship with programmes specifically designed for the targeted population, such as planning, training and the auditing policy.

For example, an amendment to the law resulting in the levy of tax being shifted from producers to the retail trade would have large implications for the way in which the Tax Administration operates and is organized.

In Canada, the Manufacturer's Sales Tax was repealed in 1991 and replaced by the Goods and Services Tax (multi-stage value added tax system). As a result, the tax roll increased from 70,000 licensees to 1.6 million taxpayers, impacting drastically on the number of officers required, the automated processing capacity, etc.

1.3.1.2. Formal powers: rights and obligations

There is a direct correlation between the mandate of the Tax Administration to promote, and enforce, compliance and the respect the state demonstrates for the individual rights of its citizens. Therefore, in its operations the Tax Administration should be transparent and assist citizens in availing themselves of the opportunity to object and appeal against decisions of the Tax Administration.

The rights of taxpayers are often laid down in a "Bill of Rights" or "Citizens Charter"³. Some of these rights are embedded into laws; others are laid down in (internal) execution directives for the Tax Administration. The major rights include:

- the right of equality before the law which, in some instances, is enacted as a ban on privileges;
- the right to be represented;
- the right of legal security, i.e. that taxes can be levied only under prior legal regulations. Legal security also entails that decisions should be implemented within a reasonable period of time and should be announced clearly to the taxpayer. It also entails that taxpayers should have the opportunity to lodge an objection or an appeal (to an impartial body);
- respect for the taxpayer, as evident both from the attitude of tax officers and from rendering (active) support to taxpayers with regard to their fiscal problems; and
- the right of privacy and confidentiality: taxpayers provide many personal and business data and should therefore be confident that these data are treated with care.

3. See CIAT *Handbook for Tax Administrations – Organizational Structure and Management of Tax Administration*, pp. 15-21.

Just as the rights of the taxpayer are matched by the obligations of the Tax Administration, the powers of the Tax Administration constitute obligations to the citizen. All powers of the Tax Administration should be regulated by law; they cannot be derived from (internal) official directives and orders. The powers discussed here refer to the area of tax officers' competence, regulations concerning tax returns and payments, obligations for providing information and rules for the right of non-disclosure for practitioners of certain types of profession, the obligation to keep books and records, a defined retention period, and the obligation to provide access. Finally, some observations will be made with respect to special powers, such as the authority to recognize a person as the representative of a taxpayer, and rights and obligations in international relationships.

The complex balance between enforcement and promotion of compliance with the law, or how can the taxpayer relationship become associated with respect for taxpayer rights?

An example of Chile:⁴

- (a) Reducing tax evasion implies not only enhancing the powers of the Tax Administration, but also substantially improving the way in which the available powers are used. This is particularly important, because any legitimate right to hold or increase the power of enforcement over time will be strengthened if taxpayers feel the administration is using its enforcement powers in a fair, equitable manner.
- (b) An apparent dichotomy must be resolved in order to improve the taxpayers' impression of justice and fairness:
 - on the one hand, there is a need to view the taxpayer as a client or user, with high-quality assistance and low-cost compliance with tax obligations considered to be aspects that require optimization;
 - on the other hand, there is also a need to focus on enforcement and monitoring activities related to taxpayers who show a tendency to evade taxes.
- (c) One way to reconcile these approaches would be the following:
 - consider that "good" taxpayers should be treated as clients or users whose acceptance of the system will strengthen and support it, and that
 - "bad" taxpayers will encounter difficulties, in terms of the costs they must face for tax offences and in terms of the time the

4. Extracted from the document on optimization proposals regarding Inspection and Tax Courts, Internal Revenue Service of Chile, Subdivision for Inspection, 1999.

Internal Revenue Service devotes to checking their actions, establishing responsibilities, ascertaining the amount of damage and handling collection procedures.

- (d) Skills such as reporting and handling objections and conflicts, perhaps not considered key issues in the taxpayers' minds until now, must be developed. This also involves providing information on concepts such as taxpayers' rights that must be explained and disseminated.
- (e) A new outlook such as the one proposed is only possible when there is "intercommunication" that guides and conveys an approach of this kind. Typical phrases or slogans such as "Good taxpayers are our clients" must be developed. We must assure these taxpayers that they are competing on an equal footing with the rest through a reduction in tax evasion. Another example would be: "Part of our mission is to dissuade bad taxpayers by clamping down on evasion and to encourage good taxpayers by facilitating services and lowering the cost of compliance with their obligations".
- (f) To fulfil this purpose, it is first necessary to achieve consensus among Internal Tax Service employees concerning the proposed approach, then to choose an adequate vocabulary to express it in, and finally to promote the approach and disseminate it through all regular contact and communications, making it a criterion used when implementing procedures such as designing processes, assigning roles and monitoring performance, etc.
- (g) The importance of this cultural change is based on the existence of a mixture of approaches at the Internal Revenue Service, where various views co-exist: a traditional view that looks at taxpayers as "potential evaders" and encourages tax service employees from building and holding a dominant position over taxpayers in every contact and relationship, an outlook we could call the "pro-IRS approach", and another approach which focuses on creating an impression of fairness and justice in the service-taxpayer relationship and on achieving further legitimacy to hold or increase institutional powers that could be called a "user-satisfaction approach".

There are many ways to pay respect to the taxpayer's rights, and at the same time promote compliance with the law. The powers of the Tax Administration should not only be determined by law, or at least be framed within it, but should also be made known to the taxpayers, regardless of the means used (paper: fiscal code; computerization: Internet site). Some examples will be discussed here.

In France, taxpayers who are subject to an audit or an in-depth verification of their tax situation (for individuals) receive, along with the notice informing them of the audit, a brochure which contains the guarantees from which they may benefit throughout the procedure. The said brochure, called “Taxpayer Charter”, is mandatory, subject to determining the control procedure if not adhered to.

In Spain, taxpayers’ rights are laid down in a specific act. Taxpayers have to be informed of their rights and duties with regard to the proceedings at the very start of any tax audit.

The Canada Customs & Revenue Agency issued in June 2000 a pamphlet with the title “What you should know about audits” and a questionnaire called “Client Service Evaluation Questionnaire”. In keeping with their mission to promote compliance through education, quality service and responsible enforcement, the CCRA sends the pamphlets to all individual and small business taxpayers who will be subjected to an audit. The purpose of the pamphlet is to improve compliance through taxpayer education. It provides taxpayers in the individual and lower-income-range corporations with an overview of the audit process as well as an explanation of their rights and obligations with respect to an audit. In order to assess the impact of the pamphlet as well as the clients’ views regarding the performance of the CCRA, a questionnaire has been developed. This “Client Service Evaluation Questionnaire” is sent out to a random selection of the audited taxpayers after the audit has been completed. All responses are gathered and analysed on a confidential and anonymous basis. This ongoing process, in conjunction with the CCRA’s other surveys and research tools, is used to improve the overall audit practices and procedures.

1.3.1.2.1. *The powers of the Tax Administration*

Tax officers should have the power to act within their official capacity. This is a necessity in itself, but it can also be important with respect to the type of duties and functions they are required to perform. Delegation of powers involves a chain delegation, i.e. each link in the chain derives its powers from the previous link. The regimen governing the delegation of powers should be laid down in legislation.

1.3.1.2.2. *Regulations concerning tax returns and payment*

Each person who owes taxes with regard to a certain period must be given the opportunity to pay his liability. The most important tool for obtaining and processing data on the liability of taxes is the (tax) return form. Regulations for submitting returns are sound if both the obligation to fill out the form and to file the returns distributed are laid down in the law. The Tax Administration must also be authorized to establish the level of the provisional assessments when the tax return is not handed in at the agreed time.

The moment of paying an assessment depends upon the type of tax return. Under a self-assessment regime, payments can be made at the same time as the return is submitted. Under such a system it is the taxpayer who has to calculate how much tax he owes. The verification of the correctness and completeness of the payments is carried out at a later date. On the other hand, under an assessment regime the Tax Administration establishes the amount of tax owed (possibly after a tax audit), using the tax return form submitted by the taxpayer. If, at a later date, an error or incorrectness in the tax return is found, it must be possible to correct this error or incorrectness within a reasonable period of time.

In most countries, a reasonable period of time for (re)assessing income and corporate tax is generally three or five years. Different periods apply to different taxes and to different groups of taxpayers (individuals or corporations). The assessment period starts either at the end of the period the tax return is about, or can start after the date the original tax return was filed. In some cases, a written agreement, executed within the statutory limitation period, between the Tax Administration and the taxpayer, can extend the period for assessing the tax. The general three or five-year limit can be modified in particular circumstances. These circumstances include situations where no tax return is filed, or when the filed return is fraudulent.

The use of financial institutions, such as banks, can mean an important improvement in the quality of the collection process and the quality of information.

For example in Brazil it is mandatory for legal persons to submit a specific form which registers the tax amounts due and allows them to link the amounts paid in the banking network to the different debits. Considering the millions of taxpayers paying these taxes through tens of millions of tax

deposit forms, it is evident that this link represents a significant improvement when compared to the previous situation.

Taxpayers should not be able to escape their obligation to pay their tax liability. Measures to facilitate the collection of tax debts include:

- giving tax liabilities precedence over other liabilities and debts;
- giving the Tax Administration recourse to claims and/or assets of the taxpayer;
- allowing setting off of tax debts against money owed to the taxpayer;
- providing force for stepped up procedures for collecting taxes in the case of suspected embezzlement of means;
- having access to third party information and accounts payable;
- providing for third party liability; and
- monetary penalties (fines) and imprisonment provisions.

1.3.1.2.3. *Obligations to provide information and to keep and retain books and records*

For purposes of verification and auditing, the obligation to provide information is essential. This can mean that the taxpayer is required to provide the data himself, but also that he/she has to provide access to the books and records. These obligations can also be imposed on third parties who hold or possess relevant documents. If a third party keeps or possesses relevant information that was disclosed to him or her in the capacity of holder of an office or practitioner of a profession (for example, lawyers and ministers of a faith), an exception can be made to the obligation to provide information. In these cases, finding the truth yields to social values considered to be more important.

For example in Canada, the Solicitor-Client Privilege gives clients the right to refuse to disclose a legal opinion to anyone, including a judge in court. This principle also applies to the Agency when it receives a legal opinion on a tax issue from a Department of Justice lawyer.

To assess the activities of internationally operating companies, especially those with the parent company seated abroad, it must be possible to retrieve information from the foreign parent company on issues related to the tax affairs of the resident corporation. To this end, an obligation to provide information on international relations should be created, and treaties for the exchange of information with other countries should be concluded. Provisions to prevent double taxation would be included in the treaties.

For corporations the triplet of obligations to provide information, to keep books and records, and to retain them forms a logical unity. Without the obligation to record the business process, combined with the obligation to retain these records, a malicious taxpayer could simply escape its obligation to provide information.

In the (tax) legislation of most countries one can find directions that describe the requirements with regard to bookkeeping.

For example, in Brazilian legislation, business and tax accounting have special requirements, such as formal statements for opening and closing accounting books certified by a professional accountant, the registration of books before the public authorities, the typographical sequential numbering of pages, etc. Any other documents and information found at the company under audit or in the possession of third parties related to that company may be used in the tax audit. However, the accounts of the taxpayer prevail over these complementary elements unless there is proof otherwise.

In France, Article 54 of the General Tax Code provides that if the accounting is maintained in a foreign language, a translation by a certified translator must be presented at the request of the administration.

Following the trend of computerization, corporations increasingly keep their books and records in an electronic format. However, to comply with their information obligations, it would not be sufficient to hand over a floppy disk to the Tax Administration: the information should be delivered in a form that is readable and comprehensible, and clearly show the nature of the transactions and their tax liability. This requires not only that the books and records are retained, but also the computer software with which the books and records are created. This, in fact, constitutes an extension of the obligation to retain books and documents.

In most countries the tax law is adjusted in order to deal with the use of electronic files.

One can find a good example in Brazil, where the Brazilian Tax Administration defined standards that have to be followed by taxpayers when submitting electronic files, containing accounting records or any other information affecting those records. The basic premise is that if the taxpayer uses data processing for the registration of his operations and the respective accounting records, there is an obligation to maintain the files,

systems and respective documentation in good order and at the disposal of the tax authority. The Tax Administration does not require him/her to store data in any specific format, but it does require him/her to submit these data in accordance with the given standards when so requested.

With the spread of information technology in the administration of legal persons, the acts that discipline its use for tax purposes have become more demanding, increasing the spectrum of those who are obligated to comply with them.

The size of the corporations and the nature of their operations influence the organization of the accounting system. Provisions concerning the organization are restricted to the type of records that should be kept. Common books and records are the cash book and bank register, and the purchase and sales journals.

Some countries provide detailed directions on how the books are to be kept. Enterprises may have to keep records of the following:

- journal (a daily account of the operations that modify the status of the company's assets);
- ledger (summary and totals of the entries in the journal);
- inventory record (periodic stock-taking);
- payments record (record of purchases of primary materials, products in preparation, manufactured products and commodities);
- permanent record of property stock (for companies in the real estate sector);
- handling of fuels (for resellers);
- log book of real fiscal profits (to demonstrate taxable income); and
- log book of the tax on industrialized products (for industries).

As an optional supplement, specific books may also be used for business records, including:

- cash-book; and
- current accounts.

The retention obligation applies to all relevant documents, and is thus not restricted to certain records. The period of time during which books and records should be retained should exceed the term during which errors are permitted to be corrected in the tax returns for years that have already been settled. Corporations with a completely computerized accounting system are required to take additional measures to ensure that certain software programs are able to convert accounting data into a readable and compre-

hensible form. As the obligation to both keep and retain books and records is essential to the obligation to provide information, sanctions for non-compliance with these obligations must be provided for.

The limitation period for keeping records as required by legislation will vary from country to country and will relate to a reasonable period of time for (re)assessing income and corporate tax.

For example, the limitation period in Canada is six years from the end of the last taxation year to which the records and books of account relate.

In the United States, the limitation period is three years but includes the possibility to prolong this period under special circumstances. Electronic records must be retained in an electronically readable format for the same retention period.

1.3.1.2.4. *Obligation to provide access*

The obligation to permit access to premises, particularly if these are residences, must be reconciled with the right of privacy and guarantees to safeguard privacy. A proper implementation of the tax laws may require a location to be searched (i.e. office building, car, home, etc.) and records to be seized. With regard to the conflict between these extraordinary yet essential obligations and the right to privacy, legal regulations for entering premises will have to be formulated. These regulations should clearly stipulate the circumstances in which these powers can be used, the authority mandated to grant them, and the process for requesting them.

In most countries, when deemed useful for any particular practices, workers of the Tax Administration may enter properties, places of business and other establishments or locations where activities or operations are carried out that are subject to taxes, where there are goods subject to taxation or where there are matters that are taxable or where proof of these matters is found.

1.3.1.2.5. *The right to be represented*

Without additional measures the relationship between the Tax Administration and the taxpayer would not be on an equal level. One of the recourses for the taxpayer is that he has the right to be represented by, for instance, a tax consultant. In other words, in the taxpayer's place an expert

enters the discussions with the Tax Administration. However, a taxpayer is not always able to recognize persons who are totally incapable of being a representative. The complexity of the legislation definitely contributes to this inability.

In all countries, taxpayers have the right to be represented by an adviser. These individuals are recognized as qualified representatives to act for the taxpayers in proceedings before the Tax Administration. These individuals may include attorneys, certified public accountants, enrolled agents, family members, officers of a taxpayer's organization and full-time employees of a taxpayer. Enrolled agents are individuals who have demonstrated their competence in tax matters and meet the requirements set by the Tax Administration. Taxpayers can authorize the representative to receive and inspect confidential tax information and to perform any acts on behalf of the taxpayer with respect to any specific tax matters such as signing agreements, consents or other documents.

The responsibility of the representative for an accurate, truthful and on time filed tax return means that in case of a false or incorrect tax return the representative can be punished. Different countries have solved this problem in different ways.

For example, in Canada third-party penalties came into force in June 2000, aimed at those who counsel others to file their returns based on false or misleading information (such as fraudulent tax-shelter promoters), or who turn a blind eye to false information provided by their clients for tax purposes (tax preparers).

In Brazil, accountants are, along with the taxpayers, responsible for any forgery of documentation or irregularity in accounting committed for the purpose of defrauding taxation. In this case, without prejudice to any criminal action, the professional may be declared unfit to certify documents that are subject to examination by the Tax Administration.

In the Netherlands, a tool to exclude such representatives is a formal refusal of the Tax Administration to accept an individual as a representative of his client(s) for a certain period of time. The representative must have misbehaved in various cases and it must be clear that he/she is not fit to do the job. When the representative disagrees, he/she can always go to the courts. As it is a measurement to punish the representative, the taxpayer can of course choose another representative: the taxpayer still has the right to be represented.

1.3.1.2.6. *Rights and obligations in international relations*

In general, rights and obligations in international relations are subject to the same principles as domestic fiscal relationships. However, national governments will not always be able to enforce these rights, while the obligations remain in force. Thus, a separate obligation to provide information in international affairs will have to be created and treaties regulating the exchange of information with other countries will have to be concluded.

With the globalization of the economy, the exchange of information and administrative cooperation between states become more and more essential in the fight against tax fraud. It is important that agreements provide for an automatic and spontaneous exchange of information between countries in the areas where there is reciprocity. In Chapter 5, section 2 (Exchange of information and international mutual cooperation), the necessity of tax treaties will be dealt with more in depth.

1.3.2. Culture

The culture of a country is a condition that a Tax Administration has no influence on or can only influence to a very limited degree. Culture differs from country to country, as has been demonstrated by Hofstede.⁵ He uses four criteria (distance to power, individualistic versus collectivistic, masculinity versus femininity and avoidance of uncertainty) to highlight the differences in culture between countries. Insight into which of these criteria prevails is necessary to identify an appropriate mission and the consequent treatment strategy that matches the culture of a country.

Besides cultural aspects, the behaviour of taxpayers is determined by a host of other considerations. These considerations constitute the basis on which a tailored treatment strategy is formulated:

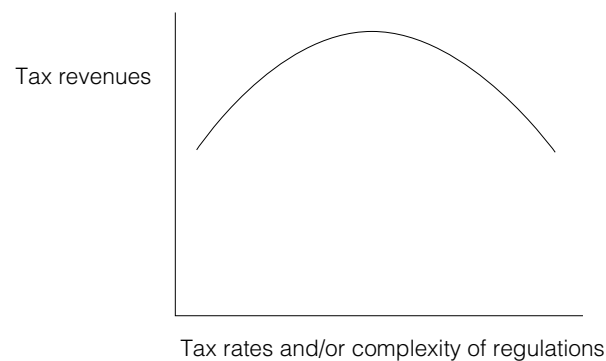
- economic considerations: the taxpayer sets off his costs (taxes) against his benefits (social benefits and the execution of tasks) provided by the government;
- legal considerations: the taxpayer tends to use the room for interpretation that the tax laws offer. Moreover, he will try to keep his tax liabilities as low as possible by taking advantage of any loopholes in the laws;

5. CIAT *Handbook for Tax Administrations – Organizational Structure and Management of Tax Administration*, 2000, p. 212.

- administrative/organizational considerations: keeping sound books and records for tax purposes (other than for business practices) involves additional expenses;
- social considerations: in one country, a high degree of compliance may exist, whereas in another country tax avoidance and evasion is a national pastime; and
- finally, elements of the tax system itself, such as the complexity of its regulations and the level of rates may influence the willingness to comply with tax laws.

It is assumed that tax rates have some optimum level. Additional increases in rates to levels above this optimum would ultimately result in overall lower tax revenues. According to this theory, the tax burden behaves as the Laffer curve. Similar assumptions exist with regard to the complexity of the regulations.

Figure 2: Tax revenue curve



1.3.3. Structure and characteristics of the Tax Administration

Primarily, the structure and characteristics of the Tax Administration are unalterable facts, as are laws. Changes in the structure can be dictated by circumstances within the context or by forces from within. The structure and characteristics should be aligned to the mission statement and treatment strategies so that the organization can operate effectively and efficiently. Treatment strategies may focus on the taxpayer, as can specialization in a type of tax and the way in which fraud and tax evasion are combated. These approaches result, respectively, in a client-oriented or

target group-oriented organizational structure, in an organization based on the various types of tax, or an organization geared to various forms of enforcement.

The characteristics include the way in which the organization is managed. At an operational level, the treatment strategy has to be translated into objectives to be incorporated in the annual plans. The degree to which these objectives are achieved is monitored by (amongst other things) periodical reports. Chapter 5 of the *CIAT Handbook for Tax Administrations – Organizational Structure and Management of Tax Administration* extensively discusses the application of tools for measuring performances, such as the Balanced Scorecard, critical success factors, and performance indicators.

Essential factors for the efficient functioning of a Tax Administration are:

- a Tax Administration must be free of political influences in its daily activities;
- a Tax Administration must be a stable organization, full of integrity and free of corruption. To prevent corruption, a good level of remuneration is necessary and Tax Administration employees are not allowed private clients; and
- a Tax Administration must be a government agency; only under secure conditions can part of the activities be privatized or outsourced.

1.3.4. Developments

The world changes quickly. The government as organizer of society, and the Tax Administration as part of that government, will have to adapt in order to meet the new demands made on the government.

1.3.4.1. Globalization and internationalization

Globalization and internationalization influence the capacity to collect taxes and to audit taxpayers, as well as the opportunities for arbitrage. Corporations that operate internationally no longer consider national borders as an impediment to their activities. In order to be able to realize a just system of levying taxes on a national level, tax authorities need to have access to all the relevant data: even if these data are abroad. So, therefore, tax authorities need to intensify their international exchange of informa-

tion and need to increase collaboration and cooperation in the area of tax auditing.

An appeal can be made to various forms of international data exchange when the information that can be obtained in one's own country is insufficient. The exchange of information should be based on bilateral, interregional or multilateral treaties containing agreements concerning the exchange of information. There is an opportunity of automatic exchange of information, spontaneous exchange and exchange on request. There also could be an opportunity of assistance in person. This means that a tax officer from one country can be present, upon request, during an investigation in another country.

Besides the exchange of information mentioned above, there could be an opportunity of simultaneous tax audits. Simultaneous tax audits are based upon an agreement between states for investigating simultaneously the fiscal affairs of a taxpayer or a group of taxpayers with regard to an agreed period of time.

Chapters 4 and 5 will give a more detailed description of the exchange of information and mutual international cooperation.

Another aspect of globalization and internationalization is that it could be necessary to change the bases of the taxation system or to amend tax treaties due to the shift in trade, capital and production flows from domestic to international channels and the emergence of tax havens. Corporations that capitalize on these trends are often the large international or even multinational corporations. The opportunity to decide in which country they will operate makes them formidable parties. A decision whether or not to have an establishment, or to relocate an establishment, has a large impact on the economy and employment opportunities in a country. Those representing the Tax Administration should thus have the background and education to manage a multi-disciplinary audit team and be able to uphold the position and the interests of the Tax Administration. As the volume of such activities increases, Tax Administrations are establishing separate audit organizations to deal with large corporations, using team audit approaches, with the assistance from specialized audit areas (international issues, avoidance, appraisers, computer specialists, etc.).

1.3.4.2. Digitization and computerization

Digitization (which refers to software and content) and computerization (referring to hardware) are two other trends that boomed during the past decade. The question which consequences the emergence of e-commerce could have for taxation has often been raised.

An answer to this question can only be given when the developments have crystallized and it becomes clear what effects e-commerce will have on the opportunities for levying taxes. However, today it is already obvious that the fundamental notion of “permanent establishment” in a tax context is challenged.

Digitization also includes the increased use of computers for accounting purposes. This development changes the way in which data, documents, accounting systems and the resulting administrative and management information are processed and used. Tax Administrations will therefore have to deal with these matters in a different manner. Practice has already been confronted with the question whether a floppy disk containing the accounting of a company is part of the “books and records” that should be handed in to comply with the information obligations.

In many countries, this question has induced an amendment of the law: the concept of “books and records” has now been extended with the concept of “data carriers”.

Intensive use of information technology resources to support the provision of information through digital return forms offers large opportunities to improve the performance of Tax Administrations. The process can be organized more efficiently (a great deal of work can be done by the computer) as well as more effectively. Electronic forms offer great flexibility and the option to seek assistance, depending on context and search resources, which significantly increases the quality of the information available. Furthermore, the elimination of the need to transcribe forms, which were formerly submitted in printed format, makes it even easier for the authorities to be faithful to the information that the taxpayer wishes to provide. Many countries offer taxpayers the opportunity to file the tax return electronically. The percentage of taxpayers that makes use of this facility varies from country to country.

The best performing country at this moment is Brazil; in 2002 100% of the tax returns of legal persons were filed electronically and 99% of the tax returns of natural persons. It must be said that legal persons are obliged to make use of the electronic filing facility.

The impact of phenomena such as globalization, internationalization, digitization and electronic commerce is very frequently analysed in international conferences of the Tax Administrations. Nevertheless, it varies per country which important challenges they have to solve:

- implementation of a reliable and updated taxpayer file;
- implementation of a database with reliable cross-checks;
- improvement of the rate of voluntary compliance with tax obligations;
- more effective enforced collection; and
- implementation of an administrative career path guaranteeing the training, independence and integrity of the staff.

Along with challenges, there is also a tremendous opportunity for Tax Administrations to increase their efficiency and effectiveness. Digitization influences the relationships with taxpayers in many ways. Communication involves rendering services (providing information), as well as processing (tax) returns internally in a digital form. The transition to “e-Tax Administration” will profoundly change the type of employees required: a large part of the clerical work is being taken over by the computer. The digital returns also present more opportunities for improving and intensifying the selection of returns that need auditing as well as opportunities for enhancing the effectiveness and efficiency of the verification and auditing processes.

1.3.4.3. Other developments

Other current developments cannot always be assessed immediately with regard to their consequences on the levying of taxes.

In these days and according to the prevailing economic models, the trend for governments is to reduce control on markets. Since the control mechanisms on which the Tax Administrations have relied in the past disappear or are weakened, it should be investigated whether compensating measures are required.

Increased individualism has contributed to Tax Administrations restructuring themselves into client-oriented organizations that are able to customize their procedures.

Global issues can affect the performance of Tax Administrations. All over the world the environment has become a major issue. This may have consequences for the Tax Administration in many areas. Prohibition of the production of and trade in certain goods is one of the measures taken to protect the environment, and may result in fraudulent behaviour with respect to environmental legislation and thus, potentially, also result in fraudulent behaviour with respect to fiscal legislation.

Other changes may result from shifts in the population with respect to both demographics and culture. The latter includes trends of increasing crime, which in their turn are an incitement to money laundering. Though it is not primarily a fiscal offence, laundering money makes the growth of the informal economy, or the black circuit, even more important.

1.3.5. Human resource management

In addition to the organizational structure of the Tax Administration, the number of employees and their level of training and education are also part of the current context. Integrity is important for the effective and efficient functioning of the organization. Defining integrity is influenced, in part, by a country's culture and the effect of politics on the executive process. Chapter 2 will cover the human resource management (HRM) aspects in more detail.

1.3.6. Other environmental factors

Other relevant factors in the environment are the geographic size of a country, the size of its economy and its influence on neighbouring countries and other trading partners, its accessibility to and from other markets, the competitive tax policies of its main trading partners, the nature of its economy (for instance, agricultural or rich in natural resources versus highly industrialized), consumer-import dependant versus exporter, the extent of control of its economy versus capital-dependant from foreign investments, policies on foreign investments, the political environment balancing social measures through the tax system versus that of an open

market, and its own customs and practices. In short, these are non-fiscal parameters that affect all activities in a country and which the Tax Administration should take into account in formulating treatment strategies.

For example, in an exporting economy it can be profitable to adopt a multi-stage value added sales tax model versus other models of consumption sales tax. A multi-stage tax with an input tax credit mechanism allows for a zero-rated tax price on exports, thus enhancing the competitiveness of national products on the international scene.

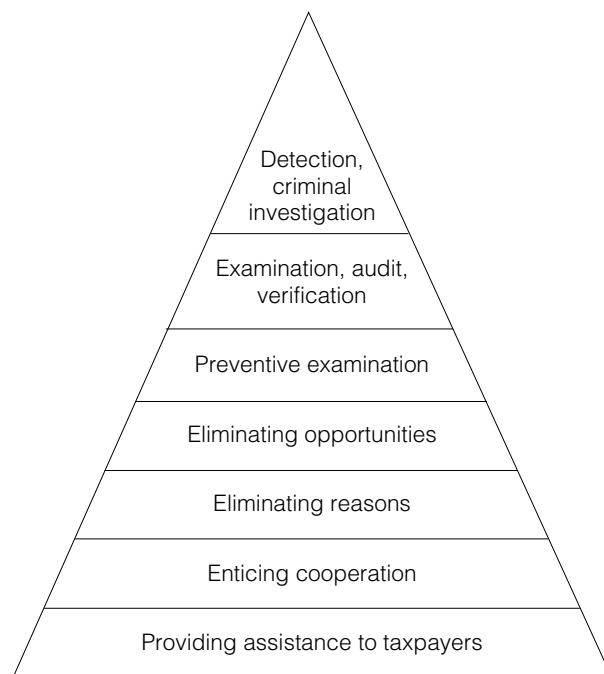
1.4. Treatment strategy and objectives

The mission statement clearly defines the central duty of the Tax Administrations and elaborates on what a Tax Administration should do. The treatment strategy should benefit from the context in which it has been implemented. The treatment strategy and the objectives to be achieved should thus be consistent with the missions that have been formulated.

1.4.1. Treatment strategies

Figure 3 shows the position of the treatment strategy concept within a triangle, the so-called enforcement pyramid. In this pyramid, all forms of attention directed at a taxpayer can be positioned. At the base are the forms of attention that have rather the nature of services or preventive measures to facilitate the taxpayers' compliance. These activities are aimed at all taxpayers. Higher up in the pyramid, the forms of attention increasingly become enforcement measures. The number of taxpayers subjected to these more labour-intensive forms of attention must be smaller, as a number of taxpayers will voluntarily comply, with or without limited treatment, and the available resources must be distributed to the various forms of treatment in the most effective and efficient way. A treatment strategy can include some or all of the following forms of enforcement, ranging from services to fraud investigations and prosecutions.

Figure 3: The enforcement pyramid



The treatment strategies in the lower part of the triangle strongly resemble the rendering of services and are aimed at influencing the behaviour of the taxpayer by eliminating causes resulting from the Tax Administration itself. These strategies are fundamental to any Tax Administration. Their extent, in relation to more enforcement-oriented measures, will vary and depend on the context in which they are set in each country (i.e. which legislation, level of education, relationship of the public with its government, the mission statement/philosophy of the Tax Administration, etc.).

1.4.1.1. Providing assistance to taxpayers

Tax legislation is almost invariably considered to be complex and, indeed, this is often the case. Taxpayers who have to deal with the Tax Administration may therefore be uncertain as to the correct interpretation of the law. Taxpayers in this group may make unintentional errors in their tax returns, mostly as a result of ignorance. By providing targeted assistance to various types of taxpayer (through Internet services, pamphlets, television commercials, (free) helplines, actively providing information to

starting corporations, direct assistance in filling out forms, and information in paper form ranging from detailed tax pamphlets on complex issues targeted at tax practitioners to simplified need-to-know brochures for small businesses, etc.), unnecessary errors in the return forms can be avoided.

Reducing taxpayer inconvenience

What do we want taxpayers to think of the Tax Administration's performance?

As many other Tax Administrations, the Internal Revenue Service of Chile has focused on analysing tax procedures with a view towards improving the taxpayers' impression of the service. This change process clearly shows the three aspects needed to improve the quality of service that should be developed to promote a new culture in the Tax Administration and achieve a new image among taxpayers, namely:

- the information taxpayers receive in the course of tax-related procedures;
- the way the IRS treats taxpayers during the process; and
- the costs incurred by the time and resources invested in the process, for both taxpayers and IRS.

Information (transparency)

Taxpayers want, need and have a right to know what the tax procedures of the IRS entail, how much time they will take and what their potential consequences are. Likewise, taxpayers want and have the right to know what rights they have in the process and what the available procedures are for reporting information or availing themselves of their rights.

If these aspects are not met, taxpayers will perceive that the process is not transparent and, consequently, consider themselves to be in a weaker position. They are also likely to feel that the inspection process penalizes them before it allows them to demonstrate their actual behaviour.

Attaining this goal will mean a consistent implementation of the transparency policy as imposed by the current government, which has stressed the need to provide taxpayers with all the necessary information relating to government tax regulations, procedures and jurisprudence in order to facilitate their duty to comply with the tax obligations.

Fair, equitable and deferential treatment

Enforcement must be effective in detecting tax irregularities and also consistent with the tax system model that prevails in Chile, based on the prin-

ciple of good faith and the taxpayer's computation of taxes. In this regard, the government's procedures must be appropriate for the intended objectives as well as standardized and uniform to ensure fair, equitable treatment with adequate quality levels when the procedures are applied.

Low cost of enforcement (efficiency)

Government inspection procedures must minimize the potential costs for the taxpayer. The amount of time required to comply with the enforcement regulations should be as brief as possible, in order to minimize any inconvenience to taxpayers and to their business activities. The procedures must be simplified to make them more comprehensible for taxpayers so as to minimize their need for inspection or accounting advice when handling inspection procedures and claims.

To facilitate the fulfilment of their tax obligations, there are various information and help services taxpayers can use. Tax declarations may even be completed for those individuals who request this. The following services are available:

Information services:

- services rendered en masse, without previous request:
 - information sessions or tax clinics;
 - publicity in mass media;
 - publication of explanatory brochures;
 - editions of handbooks on the main taxes; and
 - information letters;
- services rendered on an individual basis:
 - general taxation information rendered by telephone; and
 - consultation services to follow up the tax refund proceedings.

Help services with tax returns:

- simplified income tax forms;
- teaching Taxes Programme and programmes for new investors and entrepreneur immigrants (Canada);
- “help” computer programs (also through the Internet);
- completion of the tax forms; and
- providing tax data to every taxpayer to help him complete his tax return.

Electronic services:

- performance of administrative sanctions;

- user-friendly computer programs; and
- submission of tax returns.

1.4.1.2. Enticing cooperation and positive attitude and eliminating reasons and opportunities for non-compliance

Despite general information being made available, a number of taxpayers will need to interact directly with the Tax Administration; from a particular problem of a small business to a complex issue from a multinational with a transaction not yet or not properly covered due to current policies and procedures. A very low, first level of control or enforcement will also cause some interaction with taxpayers.

One cannot overemphasize the responsibility of senior management in ensuring that such contacts between officers and taxpayers are as professional and courteous as possible, so as to entice current and future cooperation and a positive attitude from the public.

Inappropriate delays and rudeness when answering the phone or in letters, long line-ups at service counters, abuse of power and arbitrary decisions, etc., can only generate a lack of mutual respect, resentment and negative behaviour towards the Tax Administration, intentional errors and omissions in tax returns, and a lost opportunity to promote voluntary compliance at the lowest level of intervention. As a result, more audit resources (higher costs) will ultimately be required to achieve the same outcome, in a more confrontational environment.

The treatment strategies in the lower part of the triangle are in the nature of providing service and are aimed at influencing the behaviour of taxpayers by eliminating negative experiences resulting from the behaviour of the Tax Administration itself.

Preventing taxpayer inconvenience or service standards: commitment to taxpayer assistance

In many countries there are forms of taxpayer assistance. The forms of assistance relate directly to two major developments: the rapidly growing importance of the use of the Internet and the use of financial institutions. These two important developments will lead to less personal contacts between employees of the Tax Administration and taxpayers.

In the area of taxpayer assistance, clear, specific and measurable standards must be drawn up for the various procedures most frequently performed by the taxpayers at the Service, taking into account issues such as the time required for each procedure, the time the taxpayer must wait before being served, the number of visits needed to solve the problem or handle the procedure, etc. There are different methods to measure the level of service performance. One, more mechanical, method is the use of quality indicators. A more dynamic method is the use of questionnaires in order to evaluate the opinion of the taxpayers with regard to the services they receive from the Tax Administration.

The following quality indicators are used to measure the service performance:

- the number of citizens assisted by phone services;
- the number of services rendered through Internet;
- the average time for tax refunding;
- the average time to answer letters;
- the average time for decision on appeals;
- the reception according to appointments;
- no telephone call without a follow-up; and
- promoting the use of family names in administrative correspondence.

1.4.1.3. Preventive enforcement

An approach more directed at verification and auditing is the preventive strategy. For a successful implementation of this strategy the approach must be transparent. The objective is to make clear to the taxpayer before he fills in his tax return form that as a minimum at least one or more parts of that form will be subjected to a thorough test. At the same time, the taxpayer is made aware that the Tax Administration possesses relevant counter-information for that test. The maximal effect, i.e. as many taxpayers as possible submit correct returns, is achieved through transparency: taxpayers know which part of their return will definitely be tested, and that the relevant information is available to test the returns.

An example of a preventive action is carrying out observations in corporations on site in order to register current operations and developments. This may include registering the number of persons working in a business location, the stocks in hand, checking whether the cash book is kept up to date, etc. The information gathered will in the first place be used to select the tax returns that require more attention. The aim is that the taxpayer,

knowing that the Tax Administration possesses relevant information on their taxable activities, will file a correct tax return. In that perspective it is a preventive action, though you can also see it as a preparatory activity.

For individuals, preventive measures include informing them that extra attention will be paid to one or more items in their tax return.

There are different approaches possible when helping the taxpayer.

Taxpayers know that the Tax Administration stores plenty of data supplied by third parties. This, in itself, conditions the declaration that is presented. Furthermore, it is well known that the declaration will be cross-checked on a computer with the data that the Tax Administration has at its disposal.

In Spain, the Tax Administration not only uses the data for cross-checking. The data that the Tax Administration has at its disposal is sent to individual taxpayers so as to facilitate the completion of their declarations and to avoid any possible mistakes in their completion. This initiative is aimed at individual taxpayers. A lot of other countries, e.g. The Netherlands, do not give the available information to the taxpayers, because they are not sure the available data are complete.

In Canada, a very effective, low cost initiative is to gather frequent errors and omissions made by a particular group of individuals or sectors (for example: pharmacists omitting to account for “volume rebates” provided by drug manufacturers), and advise all such taxpayers through a mail insert, or by using their associations to review previously filed returns for possible adjustments. The results for past and future compliance have been quite positive.

After having discussed the strategies aimed at providing services and at prevention, the examination strategies will now be presented. Three possibilities can be distinguished: validation, verification and auditing. In principle, it is not effective to examine fully all items in each tax return. This means that a distinction should be made between (parts of) returns that do and that do not need to be examined. That distinction is made on the basis of selection criteria.

In order to apply selection criteria successfully, a selection method must be developed. Relevant criteria should be traceable and it should be possible to use them in detection/criminal investigations. The selection process should separate returns that do not require further attention from those that

need to be verified and those that should be subjected to an audit. Simple criteria include: the time elapsed since a previous verification of audit, the industry in which a taxpayer operates, etc. More sophisticated criteria for very specific parts of a tax return require more advanced selection systems and methods.

One must always keep in mind that validation and verification are much cheaper (if well organized) than auditing. Thus, from an efficiency point of view it is important to continuously improve the validation process.

For example, in Brazil the Tax Administration periodically carries out summary reviews of the income tax return forms presented by natural and legal persons, including some specific aspects. This procedure makes it possible to quickly and electronically validate specific items on the return forms of a large group of taxpayers. Those falling within the parameters defined for the verification procedure are retained for individual analysis.

The main objective of this validation is to guarantee that the tax authorities make their presence felt among the greatest possible number of taxable persons, by a mass procedure that increases the possibility of apprehending those taxpayers who are not complying with tax regulations.

The verification and auditing policy will be described in more detail later on in this book and will not be entered into any further at this moment. In this handbook, a strict distinction is made between administrative action and criminal enforcement. Thus, this handbook refrains from further discussing the detection and investigation of criminal offences, i.e. the criminal approach.

1.4.2. Objectives

Treatment strategies particularly prelude to the mixture of activities that will be carried out. Objectives are set to give direction to activities and to specify the extent to which these activities should be performed. Objectives are formulated at the strategic level and then translated into the operational level.

At the strategic level many objectives can be defined. The mission statements of the Tax Administrations of several countries imply a number of

strategic objectives. Examples of such objectives, which may be combined in a single mission statement, are:⁶

- to optimize the correct tax revenues;
- to combat fraud;
- to increase effectiveness and efficiency;
- to operate concurrently;
- to enhance equality before the law;
- to increase the quality of laws and regulations;
- to treat taxpayers respectfully; and
- to deploy and develop the abilities of the employees.

Inseparable from the objectives is to render account of the activities that have been carried out in order to achieve these objectives. Objectives, even those for the operational level, should meet five conditions. The initials of these conditions form the word SMART. Objectives should be:

- (1) Specific;
- (2) Measurable;
- (3) Ambitious;
- (4) Realistic; and
- (5) Timely.

When translated from the strategic to the operational level, objectives should always meet the SMART conditions. They can be formulated in terms of numbers, amounts, percentages (particularly for objectives with regard to input and output), or in terms of behavioural effects (the outcome) or logistical targets (the throughput). In all these cases, targets and standards should be formulated.

Objectives also have a communicative function, both towards the employees and to the other stakeholders (i.e. taxpayers, politicians, advisers, etc.) in the organization. They explain to the employees what the organization wants to achieve and, particularly when the objectives are translated to the level of the individual employees, also what their own contribution is in achieving these objectives. To the other stakeholders, they also state what the organization aspires to.

Reporting on the progress towards achieving objectives provides valuable information on the way in which the process is executed, as well as on the adequacy of the treatment strategy selected. This information can then be

6. CIAT *Handbook for Tax Administrations – Organizational Structure and Management of Tax Administration*.

used to adapt the treatment strategy itself or the objectives. Through this feedback, a dynamic system is created in which the interrelationships between the strategy selected and the objective formulated become clear. A number of tools are available for making adjustments to the processes or the organization. They are presented in the next paragraph.

1.5. Tools

In the analytical model, tools are the elements that link treatment strategies with the objectives to be achieved. These tools can be classified into three clusters. The first cluster concerns the planning and control cycle. The second cluster contains the tools for developing the organization, structuring processes, providing ICT support and HRM. The third and last cluster refers to the verification and auditing policy.

1.5.1. The planning and control cycle

As discussed earlier, objectives at the strategic level are formulated by taking into account the context and the possible treatment strategies. Strategic objectives are subsequently translated into goals. Finally, these operational goals constitute the basis of annual programmes and action plans. In this translation into annual plans and action plans, standards and targets are used with regard to each of the objectives. It should be recognized that, given the limitations with regard to capacity and/or resources, the decision to do one thing will imply that other things must be left undone.

There is more than one planning model. Here a model from Brazil and one from Spain are presented.

The Brazilian Tax Administration provides technical, objective criteria and directives for the selection of taxpayers to be verified or audited, in such a way as to increase the degree of risk for delinquent taxpayers and, indirectly, increase tax collection. The annual Work Plan, prepared according to these criteria, is submitted to periodical evaluations, both qualitative and quantitative; with regard to its fulfilment; these evaluations are customary to all of the regional tax offices. Important directives for the Work Plan, which are repeated due to the positive results obtained, include intensifying the examination of large and medium-sized companies and carrying out tax actions with regard to taxpayers and taxes in the financial

realm, which are consistent with centrally performed studies on economic sectors.

The Spanish AEAT has a basic planning tool, the annual plan of targets, which is a basic and quantified expression of the results intended by the organization during the year. They are classified by activity areas, either in the field of attendance and improvement of the relationship with the citizens, or in the control of tax compliance. The AEAT has added a special quality programme to its planning tools. The aim of this programme was to encourage proceedings additional to those related in the annual plan of targets. The implementation of these new proceedings is essential to ensure an integrated, effective and efficient running of the AEAT.

Every year the four-year chief programme for tax control specifically directed to control areas is actualized. This programme takes into account the following factors: on the one hand, the analysis of the economic and social environment where the tax evasion takes place and, on the other hand, the subsequent application of a number of principles wished to inspire the tax audit. Among these principles we could mention close collaboration among the different administrations, a balance between the different means of control, a dynamic and proactive performance to ensure a continuous adaptation of the proceedings to the environment and an optimization of the material and human resources.

The tactical implementation of the chief programme is carried out on a yearly basis through the general plan of tax control, a tool that integrates and coordinates the control actions in the different areas of the AEAT, and includes the fields under priority control for a given year.

In order to formulate the operational objectives, an analysis of the recent trends may serve as a starting point. On the basis of the current situation, an analysis should be made of where the significant indicators, points of interest for controlling the organizations, are located. Insight obtained from analyses is used in (re)formulating objectives. These performance indicators should cover different perspectives to better monitor performance. With respect to revenues generated from the income tax, it is important to understand from which source(s) tax income emanates, and when do these flows reach highs and when lows, etc. For example, 80% of the tax revenues are received from 20% of the taxpayers: the large corporations; yet, this category often generates its revenues from the international scene, with taxable income related to a large extent to the global economy. The (natural) resource sectors are particularly prone to wide

variations. Therefore, insight is required into the various types of taxable activity and processes.

Other points of attention concern the vulnerability of the organization and the processes, i.e. the risks. These risks consist of material, formal and discontinuity risks. Restrictions to the ability to eliminate risks may result from the powers and legal possibilities given to the Tax Administration. Finally, risks can also be produced by the expectations of stakeholders in the Tax Administration.

Objectives can be established centrally or at a decentralized level. The choice between these two approaches is related to the structure and the way in which duties are organized at the head offices. If objectives are set at a decentralized level, the head office has mainly a coordinating role. These coordination duties can be in respect of various aspects, such as technical expertise, training efforts, cultural (regional) dimensions, etc. If objectives are established centrally, the head office has a directing role. It then sets the (national) parameters and imposes policies for the structure of the organization and the delivery of the programmes.

The translation of objectives into annual programmes and action plans requires insight into the capacity available and the capacity needed. The size of the available capacity is usually beyond the Tax Administration's control and is the result of political choices. Models for determining the capacity are mostly tools to allocate the scarce capacity to various activities. Insight into the capacity needed is acquired through a number of steps:

- identifying and describing in detail the work processes;
- measuring the volume of work processes;
- establishing treatment standards for those processes; and
- calculating the capacity needed.

By comparing the results of these calculations with the capacity available, bottlenecks become apparent. They are the basis for making choices and establishing annual programmes and action plans. In the long term though, the capacity available can indeed be influenced: the aim can be a smaller, but better educated Tax Administration or a choice can be made between much manual work versus extensive computerization.

The distribution of capacity and resources is realized through budgeting systems. Budgets can be allocated in many different ways. Whatever system is used, it will function properly as long as its users accept it.

Objectivity in the budgeting system increases its support: standardization is one of the ways to enhance the objectivity. Different aspects can be standardized: inputs, outputs or effects. The budget can also be set as a lump sum or through a (fixed) annual percentage increase in the budget of the previous year. It should be realized that, as standards are linked to more complex factors, the costs of controlling the organization will increase; yet, it may be more than compensated by the greater efficiency and assurance that the overall strategic objectives are tracked. Standardization not only increases the acceptance of the allocation system, it also creates possibilities for rendering account, possibly through periodical reports.

Control through the planning cycle and the budgeting system can be achieved through four complementing steering tools, so-called levers of control.⁷ Simons describes how organizations seek to achieve a balance between innovation and control, starting from the business strategy.

For successful implementation he distinguishes four key variables that should be analysed, each by their own tool (system). His theory can be illustrated by a diagram.

Beliefs systems: used to induce the search for new opportunities and to provide direction	Boundary systems: used to delineate boundaries for the search for opportunities
<i>Core values</i>	<i>Risks to be avoided</i>
<i>Strategic uncertainties</i> (<i>Critical success factors</i>)	<i>Critical performance variables</i> (<i>Critical success factors</i>)
Interactive control systems: used to create a learning organization and for the emergence of new ideas and strategies	Diagnostic control systems: used for motivating, monitoring and rewarding the achievement of certain objectives

The squares in the diagram are more or less each other's opposites; for instance, the boundary system delineates within which constraints innovation processes (in the opposite square) are allowed to take place.

7. Robert Simons, *Levers of control* (Harvard Business School Press, 1995).

Beliefs system

The core values of the organization become clear and are continuously communicated. Each person within the organization is thus permanently pointed to the direction in which new opportunities are looked for and explored. Communication can take place in many different ways.

Boundary system

The areas to be explored are delineated by identifying the risks to be avoided. Also, clearly restricting the opportunities gives direction to the activities of officers and employees, and thus to the organization in its entirety.

Diagnostic control systems

Diagnostic control systems are used to motivate people to achieve certain goals and to monitor and to reward progress. Monitoring can be done through critical success factors or performance indicators, or through control cycle systems. Through measuring, achievements can be compared against the objective. Results from variation analyses serve as a basis for adjustment of objectives. These systems operate rather mechanically and are not very sensitive to external influences.

Interactive control systems

Interactive control systems are used to create a “learning organization” and to stimulate the emergence of new ideas and strategies. The main purpose of these systems is to enhance the awareness of the organization of its environment. External signals with regard to its functioning result in adjustments to the organization. These signals can be collected both actively and passively.

1.5.2. Organizational development, structuring processes, IT and HRM

It should be continuously checked whether the organization is still attuned to the treatment strategies to be implemented and whether these treatment strategies fit the relevant context. The starting point of this analysis is the existing organization. How is the Tax Administration structured: is it client-oriented, tax law-oriented or process-oriented? Is the emphasis with regard to employees on jobs or abilities? How is the organization directed and managed?

Society changes continuously and fast. These changes impact the functioning of the Tax Administrations, which occasionally also adapt to these changes. Processes of organizational changes can only be successful if they meet the following three conditions:

- people must have a clear and urgent sense of the necessity of change;
- the ultimate objective of the changes (where does the organization ultimately want to be) must be known and understood by everyone; and
- the initial steps in the change process must be recognized and accepted.

If the organization succeeds in its change process, the first condition will be increasingly less important in subsequent changes.

Part of the organizational structure is the way in which the enforcement process has been arranged. The demands that this enforcement process must meet result directly from the treatment strategy selected. If operating concurrently (i.e. verifying and auditing at the moment the business operations take place) is essential for the enforcement process, risk analysis must make it possible to select the right cases. If the organization is built upon the client concept, accessibility to all relevant tax information of the client is a prerequisite.

Not only structures and processes have an impact upon the ability to translate treatment strategies into objectives to be achieved, but the tools do so too. In addition to accommodation and office equipment, computerization is the most important and expensive component. Investments in computerization will influence logistical aspects such as processing mass data flows (increasing the efficiency) and elements of enforcement (increasing the effectiveness of case selection).

Organizations first consist of human beings. They are the real capital. In formulating objectives, an assessment must be made of the extent to which employees possess the required capabilities. If the answer to this question is negative, or if they have the wrong competences, further action must be taken. The educational level of employees must be adjusted to the demands or, alternatively, the availability of tools (such as checklists) should be increased.

Considering the complexity of tax legislation Tax Administrations must strive to give a technical pattern to the auditing work done by its auditors. One initiative can be the publication of manuals on taxes and their respec-

tive applicable auditing procedures, to serve as a reference to relate and index the tax legislation concerning the specific objectives of each tax audit. Furthermore, these manuals contain the rules of the procedures and examples to facilitate the auditor's field work. A good manual guarantees a minimum performance level, offers assistance to the auditors and contributes to a greater transparency of the Tax Administration as a whole.

1.5.3. Verification and auditing policy

The chosen treatment strategy determines the particulars of the enforcement policy. This policy can be targeted at aspects of servicing and prevention, aspects of verification and auditing, or of a mixture of both groups. A distinction should be made between the verification and auditing policy (Chapter 3: on risk management) and the execution of that policy (Chapter 4: on tools).

The prevention policy includes a wide range of measures, varying from creating fraud-proof legislation, to actively and passively providing information, focusing on the prevention of errors, and operating concurrently. In section 2.3. of this chapter, extensive attention has been paid to the way in which the feasibility and enforceability can be taken into account in preparing new laws. In this approach, legislation is part of the measures aimed at prevention.

Other measures have mainly the nature of services. These services can be intended to prevent unnecessary errors in filling in the return form by the taxpayer. This policy is implemented by providing information and educating the public. Education and information can be provided through pamphlets, commercials on radio and television, advertisements in newspapers, Internet and specialized journals. In some countries it is possible to fill in the tax return with the assistance of the Tax Administration. Simplification of the return form and enhancing the readability may be supplementary measures to prevent unnecessary errors.

Operating concurrently is a preventive measure that is part of the verification and auditing policy. This entails that the Tax Administration starts its procedures as soon as taxable acts according to a tax law occur. In this approach the Tax Administration does not wait with its operations until the taxpayer has submitted a tax return himself. The connection between the infringement (wrongfully completing the return form) and the immediate response with a quick sanction will be apparent.

The verification and audit policy includes many activities. On the basis of the treatment strategy it is decided whether or not to make distinctions within the entire population of taxpayers and to identify different subgroups. For the subgroups thus defined, an enforcement policy will be formulated.

The next issue is to decide whether selections should be made (within each subgroup) or to adopt a one-to-one policy. Taxpayers can be selected in various ways: according to tax at risk or importance, business activities, industries, periodicity, the type of fraud or misuse to be combated, type of tax, etc. Irrespective of which approach is chosen, this selection process invariably consists of three steps:

- which criteria the selection should be based on (for example, where are the risks located? What business activities exist? Which types of fraud can be distinguished?, etc.);
- how to separate returns that require a check from those that do not?; and
- how to treat the taxpayers thus selected?

Measuring and analysing the results creates a learning cycle within this process.

Selected problems are dealt with effectively. Which methods are the most appropriate depends upon the nature of the problem. Thus, in one case support by tax officers using a treatment plan or (elaborate) checklist geared to the problem can be a suitable approach, whereas in another case exploiting counter-intelligence provides the most effective solution. Other remedies may be intensive collaboration with other bodies, or initiatives to amend the law.

The possibilities for solving problems also depend upon opportunities for computerized support. For example, in order to be able to use counter-intelligence through computer systems, information must be processed on the basis of unique identification numbers allocated to taxpayers. In addition, counter-intelligence should be available on time and be of sufficient quality. This places heavy demands upon the source of the counter-intelligence. Auditing computerized accounting systems also requires tax auditors with special knowledge, for instance EDP auditors.

Implementing the verification and auditing policy requires knowledge to be combined to help to decide from which perspective selections are made. The structured input of knowledge is also required in devised approaches

for dealing with the selected taxpayers. Knowledge can be organized according to the same categories as those that are used in the selection process: according to tax law, industry, or target group. Knowledge can also be bundled according to specific subjects that need not necessarily coincide with other organization perspectives such as ICT knowledge.

CHAPTER 2

ORGANIZATION, HUMAN RESOURCE MANAGEMENT, AND PLANNING AND CONTROL

2.0. Summary

Chapter 1 discussed various tools as part of the analytical model. These tools can also be called “functions of the organization”. This chapter covers three of these functions from the angle of the verification and audit activities.

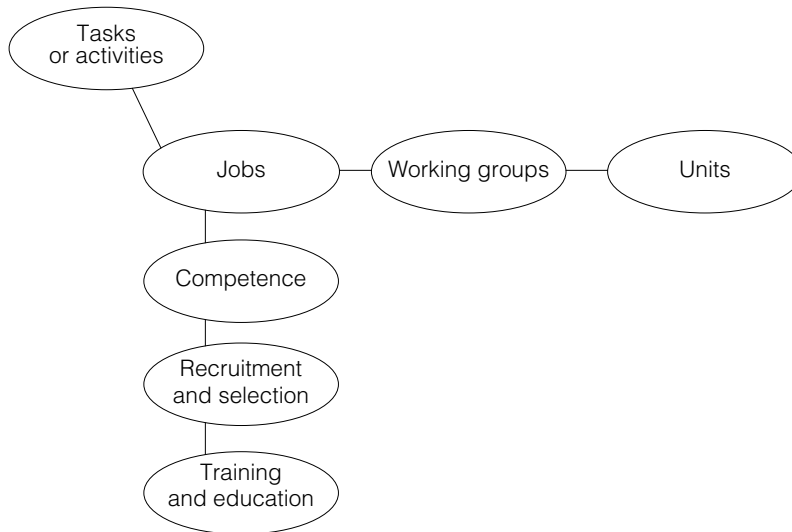
In section 2.2., some organizational aspects are discussed with reference to the *Handbook for Tax Administrations – Organizational Structure and Management of Tax Administration* (CIAT 2000). Some starting points for organizational development are discussed just as for project management, a special form of organizing enforcement activities.

Section 2.3. covers human resource management, providing an integrated approach for recruitment and training. The organizational aspects as well as the human resource aspects are a logical result from, and are in conjunction with, the tasks to be performed by Tax Administrations.

Finally, section 2.4. covers the planning and control functions in terms of processes and importance.

2.1. Introduction

Tax Administrations are enforcement organizations by nature, specialized on tax laws. The tasks and activities that follow from this mandate will be described from an organizational point of view. Tax Administrations, as any other organization, have to deal with the fact that resources are scarce in relation to the goals to be achieved, and more so at the highest technical levels. The attention of these organizations must then be focused on an effective and efficient use of such human and financial means so as to detect the main areas of non-compliance, and on a timely basis.



There are four main areas of non-compliance. First is the completeness of the registration of taxpayers (the non-registration gap): the taxpayer must be known and registered before the levying of taxes. Registered taxpayers must then file their tax returns and pay the amount of taxes due (the filing and collection gaps). Finally, the verification and audit functions ensure that the tax returns are correct and complete in accordance with the law.

This chapter focuses essentially on the verification and audit aspects. Sections 2.2. and 2.3. will discuss how these functions can be organized, and what their relationship with human resource management is, as illustrated in the following model.

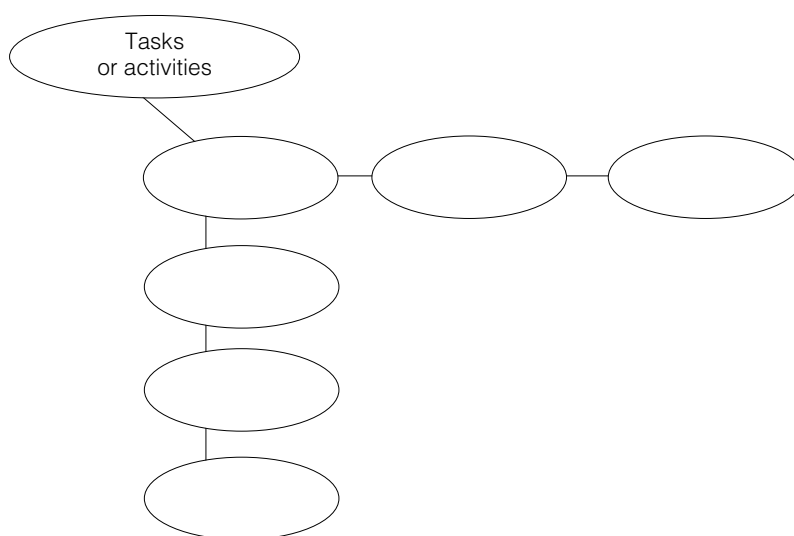
2.2. Organizational developments

2.2.1. Introduction

The purpose of verification and audit is to ascertain taxpayers' compliance with their legal obligations, and promote compliance through a level playing field for all taxpayers. Non-compliance may result from deliberate attempts to evade tax, or honest mistakes due to ignorance and complexity of legislation. Risks can be described as the probability of non-compliance within a specific context, which needs to be defined in order to be understood and properly addressed (by sector, size of enterprises, etc.).

Risk management consists of a comprehensive approach to determine potential non-compliance areas and allocate resources accordingly. Chapter 3 provides more details of risk management, risk analysis and the enforcement pyramid. In terms of efficiency and effectiveness, risk management and risk analyses will result in various enforcement activities such as (computerized) validation, verification and audit.

2.2.2. Tasks or activities



Different countries use a variety of different terms for activities related to enforcement or the same terms are used but with another meaning. Therefore, it is necessary to start by describing the terms that will be used in this handbook: validation, verification and audit. Validation, verification and audit are activities that are part of the primary processes of a Tax Administration. These activities include reviewing correctness, timeliness and completeness of the information provided by the taxpayer. The whole of primary processes is described in Chapter 3 of the *Handbook for Tax Administrations – Organizational Structure and Management of Tax Administration* (CIAT 2000). The three activities are part of the examination function of the enforcement process.

Validation is a process of (computerized) primary review and can be described in the following terms: data capture of all tax returns (mass pro-

cessing) for accounting purposes and detection of miscalculations and other inconsistencies. There is no or limited interaction with the taxpayer, essentially through correspondence such as form letters.

Verification is the process also known as documentary desk review or desk audit. Tax returns that could not be validated by the computer will be verified. The verifier uses internal information and the contact with the taxpayer is mainly by letter, telephone or e-mail but also a personal contact at the office of the tax administration is possible. Verification can also be used to review returns, such as for small enterprises and/or special projects focusing on specific deductions, more analyses of a special sector, etc.

Audit is the process also known as examination, external control, field audit or accounting audit. The audit is usually performed at the taxpayer's premises and involves auditing the books, files and records of the taxpayer.

The activities of the examination function can be organized in many different ways. In some countries the Tax Administration is organized according to the above distinction in tasks. For example, in Canada the organization of the Tax Administration reflects the three activities:

Initial (computerized) validation

This is the first step of control (usually through mass-processing by entering the information into a database), providing an initial assessment of the tax return in terms of completeness, accuracy, supporting documentation, and a basic risk assessment based on preset criteria requiring limited judgement/discretion.

This function is performed in Processing Centres and is staffed mostly by clerical level personnel. Any major discrepancy is referred to the Office Examination Division. This clerical level personnel is not part of the staffing feeder group for the verification and audit function.

Verification

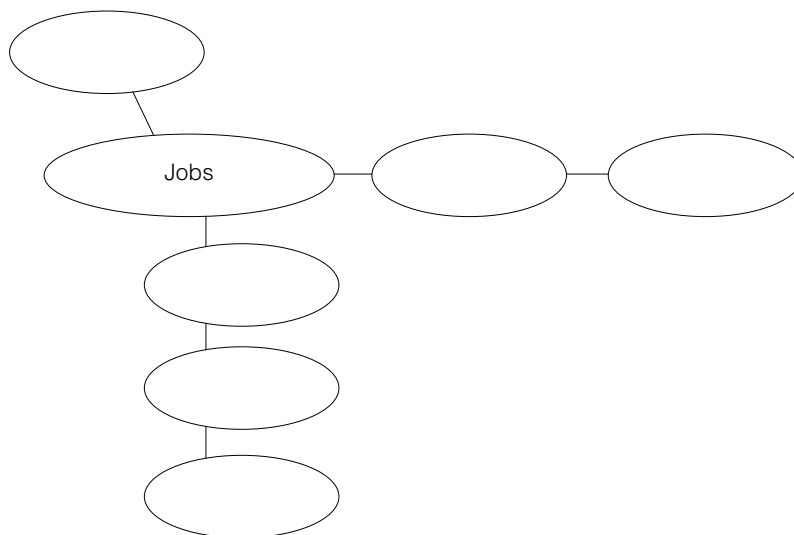
Verification consists of a "desk review" of tax returns, mainly for individual taxpayers with limited business income such as farmers, professionals and small enterprises. Contacts with taxpayers are either done by telephone and/or letters. There are no site visits; however, the function provides an efficient level of risk assessment and use of resources. Unresolved or suspicious cases are transferred to the audit function.

Audit function

The audit function supports the mandate of the Tax Administration to promote compliance to the tax legislation(s) through a balanced programme of education, service and responsive enforcement. Its role consists of auditing on site source documents, books and records, and income tax returns of all sizes of enterprises and corporations.

In creating an organizational structure, it is necessary to group the different kinds of activities, related to validation, verification or auditing into individual tasks and jobs, then regroup them into sections, then into departments. The way activities are combined into jobs and operating units will affect such matters as the efficiency of coordination and control, specialization, as well as the cost of performing such activities. Hence, jobs must be assigned to the most suitable persons, taking into consideration the degree of difficulty in dealing with specific taxpayers, the level of knowledge and expertise required, and the degree of discretion and autonomy of the employee. Other factors influencing the structure include geographical considerations (size of country and level of concentration of economic centres), the availability of expertise, and the cultural/management approach to (de)centralization.

2.2.3. Grouping of activities into functions or jobs



In practice, however, there may be some jobs with mixed activities which allow for varying emphasis and in which verification and audit activities are partially integrated. For example, to accommodate the workload and provide greater flexibility in smaller offices, or in dealing with low-range complexity of files.

2.2.3.1. Verification

Verification implies the analysis in the office of the various data contained in the tax return, to assess the reasonableness of the information, and to assess the consistency with various cross-check data available (ratio of amount of turnover to number of employees, VAT rates, and exemptions/deductions are in line with the nature of business activity in that industry, and match with information provided by third parties, such as social security organizations or banks).

Although there are no site visits, verification can provide an efficient level of risk assessment and efficient use of resources, at the lowest cost possible. Inconsistencies and anomalies revealed by document verification result in requests to taxpayers for further information. Contacts with taxpayers are either by telephone and/or letters. If no satisfactory explanation is forthcoming, the return's inadequacies give rise to the issuance of adjustment notices or a referral for audit.

Verification may include the following tasks:

- assessing the plausibility of tax returns through verifying data and evaluating third party information;
- verifying, analysing, and interpreting annual statements in order to obtain a proper picture of the company and to assess the plausibility of the profit declared;
- settling objection notices and imposing any additional assessment, possibly with increases;
- proposing taxpayers to be subjected to an audit of the books and records; and
- providing expert advice in appeal cases.

The differences in the level of verification are caused by the complexity of the tax returns. In general, there is a relationship between the size of the enterprise and the complexity of the tax return: the larger the enterprise, the more complex the tax return.

2.2.3.2. Auditing

If the reviewing of the records and explanations, which the taxpayer has provided, does not permit the clarification of the company's fiscal position through verification, the Tax Administration may undertake an audit at the company's premises. The auditor carrying out the audit may investigate relevant books, files, records and documents used in the company. The audit is a valuable tool for an assessment of the taxable amount, which more closely concurs with the actual situation. Because of the difference in complexity, many countries have an organization with different units for the audits of large/multinational, medium-sized and small enterprises. To address problems arising from the broad spectre of activities of enterprises, all kinds of support systems exist for the auditor. These systems can vary from working in teams specialized in certain line(s) of business to support from various specialists (not only fiscal specialists).

Auditing may include the following tasks:

- gaining insight into the nature and operations of the company and its internal organization;
- checking the accounting system for its correctness, timeliness, completeness and plausibility with respect to the registration of the business activities in its books and accounts;
- assessing the existence, structure and functioning of the accounting organization, as well as the internal control measures included; making risk analyses and assessments which are based on, amongst other things, the outcomes of quantitative analyses and industry characteristics; and
- performing audits/examinations of books and records by following detailed audit programmes.

The duties at higher levels of complexity usually have their origin in issues and problems which laws and regulations do not provide for or do so to a limited extent, and which require thorough investigations. These investigations should contribute to resolving the issue concerned, to prepare a defence in material positions, and to protect interests in the contacts and negotiations with various groups in society in which the essence of fiscal policy is at stake. In addition, an auditor at such a level must be responsible for providing substantive support, particularly to auditors of a lower level.

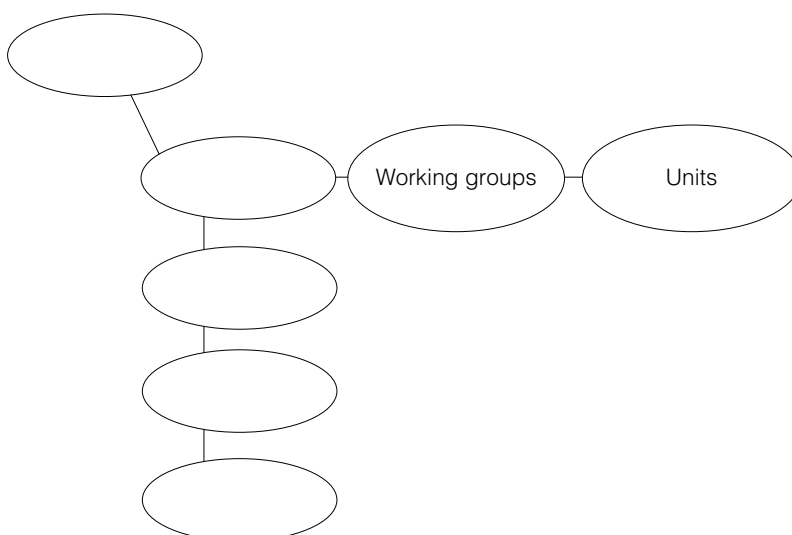
2.2.3.3. Relationships between and within levels

Within the different levels of complexity of activities, different roles can be distinguished at each of these levels. This distinction particularly refers to the level of knowledge and the degree of experience of the officer concerned, and ultimately the classification of staff, as a sound policy for motivation and retention.

The employee who has entered the Tax Administration starts at the junior level and has to learn the trade. The employee does so through progressive technical courses, exposure to increasing complexity of files, and with the support and guidance of a more experienced employee (on-the-job training). The junior officer not only learns the style and contents of the organization, but also the values and standards of performance expected. The emphasis lies on the competence and integrity of the behaviour of officials while performing their duties, as a prerequisite for a Tax Administration to establishing credibility.

Cohesion is not only required within levels of activity, but also between the different levels of activity. The well-performing employee may (by gradually marching through the levels) reach the top position at the highest level. This employee deals with the most complex cases. The duties must be carried out within a broad, multi-disciplinary context. The employee gives counsel and is the source of information for the less experienced employees, and the person who determines the substantive weight of their level.

2.2.4. Grouping of functions in working groups (teams), divisions/sections and departments



After the grouping of the activities of verification and audit, the next step in the process is the grouping of these functions into teams and offices. This approach of the organizational structure will lead to the establishment of local offices (units), (inter)regional directorates and a central directorate.

As described in the CIAT Organization Manual, Tax Administrations make a distinction between the organizations at the central level and the operational (field) level, and further segregate their organization into one or a combination of the following models:

- functional approach;
- tax legislation approach; or
- taxpayer-oriented approach.

Characteristics of a functional arrangement of the organization are:

- a high degree of specialization of functional tasks (i.e. verification and audit);
- internal orientation; and
- support of IT can be of a relative simple nature.

An example of the functional model at the central level is the Canadian situation.

In Canada the functional model is the core component of the Agency's accountability regime. The model reflects the vision and values that underpin the department's approach to planning and managing its programmes and services, and allocating its resources.

The functional model vests overall accountability for national policy and programme development, and the achievement of the national programme results in the headquarters functions (programmes).

The responsibility for programme delivery (and input into policy and programme development) is assigned to the regions, arising from the decentralization of operations to the field, with numerous points of service delivery (six regions and 43 Tax Service offices reporting to the regional offices).

Key roles and responsibilities of headquarters and the regions

Headquarters functional programmes are responsible for:

- carrying out strategic planning for the functions assigned to them:
 - setting national priorities, short- and long-term programme goals and priorities; and
 - determining specific programme results to be achieved nationally;
- developing annual business plans for their business line, function or programme in consultation with Regional Operations;
- providing the regions with the required support to achieve targeted programme results, and client service standards;
- providing the regions with functional and technical advice and directions on specific programme issues, such as training, risk management, and on selected case/file management of national importance or those that have significant programme impact;
- monitoring and reporting programme performance nationally, and conducting quality assurance activities; and
- communicating the Agency's priorities, goals, and activities to clients and stakeholders.

Regional organizations are responsible for:

- establishing a regional management structure consistent with programme and corporate strategies, priorities, goals and values:
 - setting region-specific priorities and objectives; and

- managing regional resources, including human resources;
- delivering high-quality programmes, client service standards, and services to support national programme objectives and targeted results:
 - determining, in consultation with headquarters, regional operational results to be achieved, consistent with the level of approved resources; and
 - achieving targeted results, within the context of regional pressures and challenges;
- providing input into the design, development and implementation of national policies and programmes:
 - providing advice to headquarters branches in the setting of national objectives and priorities;
 - monitoring operational performance and reporting results; and
 - identifying improvement opportunities for programme and systems development.

Characteristics of a law-oriented arrangement of the organization are:

- a high degree of specialization on the law;
- internal orientation; and
- support of IT can be of a relative simple nature.

Characteristics of a taxpayer-oriented (or integrated) arrangement of the organization are:

- integrated approach of all tax aspects of taxpayers;
- knowledge is aimed at the taxpayer and the line of business he/she is working in, more than specialization in tasks or law;
- support of taxpayer-oriented IT will be of a relatively complex (and expensive) nature; and
- extra increase in knowledge and experience of tax employees.

It is not incidental that for special category taxpayers countries create a taxpayer-oriented part of the organization.

For example, in France, a single Directorate of Large Enterprises has been created in Paris, specifically aimed at increased effectiveness in facing the fiscal problems linked to the phenomena of globalization, which are particularly sensitive in large enterprises where the issues at stake exceed the national framework. However, the taxpayer approach is not limited to large enterprises. Every enterprise has its own liaison with the Tax Administration. This person is responsible for maintaining the contact with the taxpayer, he ensures the completeness of the tax files, addresses

taxpayers who do not comply with their obligations and who levies the taxes. This structure, already in place for large companies, will be introduced before the end of 2005 for medium-sized and small companies.

Most commonly a combination of the different models exists in the organization; for example, at the central level a functional model and at the local level taxpayer orientation.

For example, the Brazilian Tax Administration has instituted special units for financial institutions and international affairs. Its two basic objectives are to allow for closer and more in-depth monitoring of activities whose specificity requires special treatment, and to disseminate, among the other units of the Tax Administration, the knowledge obtained during these activities.

A new development is the creation of two units, to be exclusively dedicated to enforcement activities. In fact, this is partly a return to the functional model. The creation of these specialized units is aimed to separate the audit/verification activities, where most of the country's largest taxpayers are located, from the tax authority's other duties such as evaluation, collection and services to taxpayers, which are performed by other Tax Administration offices.

The existence of a unit specialized in international affairs is essential for following complex issues that arise from, or are enhanced by, globalization. Due to these issues, this special unit is structured into divisions specialized in the three major objectives of the auditing of international affairs:

- transfer pricing;
- taxation on international basis; and
- customs valorization.

Based on experiences in these areas, the systems for selecting the taxpayers to be examined and the systems of support for tax auditing are nourished to permit the dissemination of the knowledge obtained.

Generally speaking, the advantages of the functional or law-oriented model are the disadvantages of the taxpayer-oriented model. In contrast to the high degree of specialization on law or functional tasks, less is known about the line of business of the taxpayers. On the other hand, a taxpayer-oriented organization is also more externally oriented, has more knowledge of the lines of business and as such is less specialized in law or func-

tional tasks. Despite the advantages of specialization, there is a tendency that as a result of the complexity of the society and the stronger focus on the taxpayer as a taxpayer, organizations tend to be more of a hybrid these days.

The Spanish Tax Administration is currently (2003) analysing the possibility of creating special units that would assume the three tasks (validation/verification, auditing and collection) for “certain” taxpayers.

It has been observed that in some cases tax debts are being shifted toward organizations with little or no assets, making the tax payable impossible to collect. For an extensive description of the organizational structure of Spain see Appendix 2.

Audit units are regrouped into local offices, and local offices report to (inter)regional directorates and a central directorate. Every Tax Administration in the world has a central body, sometimes as an independent office, sometimes as part of the Ministry of Finance, which has the responsibility to design the audit strategy of the Tax Administration. This central directorate is also responsible for the enforcement strategy and for the implementation of this policy.

To this central directorate and possibly to some (inter)regional directorates the various local offices, units (including separate units for verification and auditing), teams and individual tax auditors are subordinated. From this it can be deduced that the following officers are responsible for the implementation of the enforcement policy: a director at the central directorate (possibly a director at a regional directorate), heads of local offices, team managers and individual employees.

2.2.5. Organizational development

An important question for every organization is whether the present model is still adequate for the task to be performed. At what time should the present model be changed into a new one, or when should the functional model be changed for the taxpayer-oriented model? It is not possible within the context of this handbook to deal with all matters relevant to this question. Each administration operates within its own context, expectations, resources and culture. Nevertheless, here are some considerations.

The first task is to analyse the present model: what goes well and what does not? This analysis can only be made if the organization is in control of the execution of the work plan; e.g. when the objectives and output are clearly defined and the production is correctly registered for the needs of management. This seems obvious but can be biased because, if the organization is not in control, there is a managerial problem. Also, reorganizing the structure does not in itself solve that kind of problem. Moreover, a profound knowledge of the cultural patterns is essential for the reorganization strategy.

The next question is what change is expected to be achieved: higher output (or higher tax revenues); a change in attitudes and improved motivation of the employees; better adaptation to the environment? Are the expected improvements to be partially, or in totality, provided by the structural changes, or does the Administration need to consider other elements?

Once the process of reorganization starts, it is important that the steps taken and the pace of change can be handled by the organization. It is better to take two small steps that can be handled by the organization than one (too) big step that cannot. Furthermore, it is of interest to realize that reorganization can create extra and (exceeding) cost of adaptation of the management information system.

2.2.6. Project management

2.2.6.1. Introduction

Even when the choice for a certain type of organization was made deliberately, there can still be a fiscal risk present that asks for a different approach. If these risks occur, one may prefer to infringe on the standing organization, for example, by choosing for project management. When regular verification or audit activities discover certain fraud patterns or fiscal schemes (constructions) or new sources of counter information, the organization must have the possibility to transfer the discovery to a national level. The same goes for special or unique projects to be handled by the Tax Administration.

The involvement of the national level is not only necessary due to the importance of the fraud or sources of counter-information, but also because of the aspects of policy, politics and publicity of such an approach.

Besides, a national approach guarantees the proper considerations regarding legal and operational issues.

2.2.6.2. Characteristics of project management

In tackling fiscal risk, the Tax Administration may decide to deploy the structure and tools of project management. Project management is characterized by:

- phasing: initiation feasibility study, preliminary investigation, execution and evaluation;
- coordination by one central project department for intake, start-up and progress control;
- obligation to report any project going on;
- decision-making at overall level: a standing steering group for feasibility studies and preliminary investigations, central management responsible and in charge of nationwide execution of actions and projects;
- use of standard scenarios, plans of action and software;
- progress control; and
- standardized reporting.

Different kinds of projects

Projects can be distinguished according to their coverage: regional projects for regional risks, or national. Essentially, both types are forms of nationwide projects; it is just that some risks may be limited to one region. For example, the fiscal risks of offshore fishing are, in principle, of a national level, but only a few areas of the country have seagoing fishermen among their taxpayers.

Projects may also differ in size and in their consequences for the Tax Administration. For instance, tackling a fiscal risk in the hospitality business will require greater effort than dealing with a fiscal risk in exploiting zoos. The nature of the fiscal risk also may make a difference: bringing to light concealed sales or discovering unreported staff requires more investigative action than supervising a warranty arrangement in a certain business. These differences may result in the need to make a distinction between nationwide actions (high impact) and targeted searches (less impact). The terms used to describe projects and actions refer to their impact.

Projects may also be initiated following the detection of (a case of) fraud. This will result in the danger that all attention is focused on a small number of large cases of fraud, while the fiscal risk is brought about by a far larger group of taxpayers. Usually, risks show a pyramidal shape: many cases of small fraud; in the middle a group of fraud of significance; and at the top a small number of cases in which fraud has grown into large amounts. When fraud departments pay attention only to that fraudulent top, they forget to deal with the underlying causes. After some time a new fraudulent top will emerge with different persons. Therefore it is necessary to reveal the underlying causes and find a strategy to eliminate them. This can be accomplished through cooperation with the regular tax offices.

Projects may also be targeted at a special location. Examples of such projects are investigations into:

- a sizeable building project, or a cluster of building projects;
- the construction of a road, railway, waterway, etc., including all technical facilities;
- a large event, such as an international sports event;
- an industrial estate, or a harbour area where there is much illegal dealing;
- a residential area with substantial social depravation and many unlawful activities.

Characteristically, these locations are not selected because this is not where a company is established, or where its head offices are located, but rather where particular activities take place. The phasing, decision-making and process monitoring activities equally apply to projects targeted at a specific location. The difference is usually the duration of the project: building sites and infrastructure works often take many years to complete, causing the attention to slacken. Alternatively, the amount of attention is maintained at a high level in spite of the risks that have already been covered. Moreover, the efforts by the Tax Administration may cause risks to shift. Lengthy projects, therefore, must always include a planning stage of one year at most with its own objectives, analyses, risk assessments and reporting.

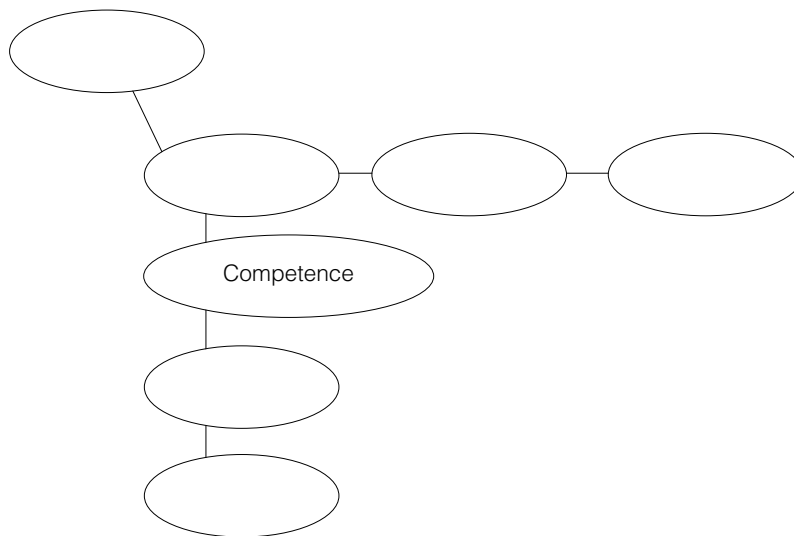
2.2.6.3. Planning and control of project management

Because of the special status and the new aspects involved in a project there is an extra need for adequate planning and control tools. Planning will be difficult because the project will almost always encounter a new

and unknown field of fraud combat. The preliminary investigations serve not only as a means of getting to know the kind of fraud and the possible tools to fight that fraud, but also for setting the first standards in this field. After the start of the project it is necessary to keep gathering the information to continuously evaluate the development of the project. It is essential that any deviations are reported as early as possible. Thus, a first measure can be the number of announcements issued, or the number of initial meetings. Measures for later in the process are also important, both quantitatively (numbers) and qualitatively (yields and number or hours spent). The numbers must be collected in tables, highlighting special situations and laggards. For the controlling of processes direct, multi-staged responses should be available.

2.3. Competence profiles, recruitment and selection, training and education

2.3.1. Competence profiles



A competence-based human resources system is rooted in the idea that good performance will result from having the right people, in the right jobs, at the right time, with the right skills and abilities. A competence can be defined as any observable and/or measurable skill, ability, knowledge,

or behavioural characteristic that contributes to successful job performance. The activities and responsibilities identified for individuals who carry out enforcement policy are the basis for the competences associated with these jobs. There are generally two major components of a competence: the definition and the scale.

The definition explains what the competence means. This provides a common language that everyone in the organization can understand in the same way.

Each competence also has associated levels of proficiency, or a scale, that generally lays out a behaviour pattern for each level: e.g. expert capability, in-depth knowledge and capability; solid capability and good working knowledge; basic capability; or basic awareness.

Competence profiles are generally developed for each job in the organization. A job competence profile is a set of pre-defined “key” competences and associated proficiency levels required for performing successfully in a specific job. Concerning the individual employees, the focus will be on the job competence profiles of verifier and auditor positions. However, because they are not the only persons responsible for the quality and quantity of the tax assessments imposed or audits carried out, there is also – sometimes only briefly – attention for the competence profiles of other jobs engaged in the levying and auditing process.

The following job competence profiles will present the competences of: verifier and auditor jobs; the head of a unit; the head of a department; a team manager; and the director of a central directorate (which may also apply to a director of a(n) (inter)regional directorate).

Individual employees must have the competences to contribute to realizing objectives and targets of their organization and team. Each individual team member must be fully aware of the mission of the Tax Administration and of the expected integrity. The team member must operate in line with the corporate identity strived after.

More specifically, employees engaged in verification and auditing are expected to have the following competences:

- effective interactive communication;
- writing skills;
- appropriate level of self-confidence;
- knowledge of principles of good governance;

Competence profiles, recruitment and selection, training and education

- knowledge of legislation, policies and procedures;
- knowledge of rules of evidence (specially verifiers);
- knowledge of auditing (specially auditors);
- knowledge of office technology; and
- knowledge of supporting Tax Administration values.

The Tax Administration should also have a catalogue that lists and defines all of the competences of their organization. This allows everyone in the organization to have a common understanding of what a specific competency means to the organization.

Note that in some countries auditors will never act in a legal procedure, whereas in other countries they will, mostly as an advisor. Besides, in some countries the difference between verification and auditing is not that clearly defined or does not even exist; in those circumstances also the documentary auditor needs to possess the same knowledge as a verifier.

In addition to the above-mentioned competences that are more general in nature, the following proficiency levels can be associated with these competences. Tasks at a low/medium proficiency level are normally carried out within detailed contexts and according to strict guidelines in areas which are limited in nature and extent, but which do require some analyses, approaches, interpretations, responses and behaviour determined by the employee himself.

The low/medium level activities may include: providing information on issues of a more general nature and taking care of the correspondence about routine issues within the tasks as well as contributing to the transfer of experiences, practical knowledge and factual information, and taking part in discussions in a rather supportive role. This level also includes organizing one's own work.

The general tasks at a high/medium proficiency level include organizing one's own work and, as the occasion arises, (assisting in) supporting the activities of others, particularly employees at the medium level, and conducting discussions (negotiations). Usually, interfaces exist with other disciplines on which to interact. Officers at this level must take into account social interests and issues such as financial, economic and fiscal/juridical interrelationships.

In addition to practical insight, experience and problem-solving capabilities, the competences required at a high/medium level are primarily

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advanced knowledge of tax legislation and regulations, and of theoretical foundations. Also, an openness for matters beyond the employee's own discipline is required, particularly with regard to developments in society that may be relevant to fiscal processes.

The competences required at an advanced/graduate proficiency level are connected with abilities for analytic and systematic/methodological thinking, applying creative sense, innovative problem-solving, and independent judgement, as well as the ability to apply consulting and negotiating skills in situations which have a politically/administratively and fiscally/legally complex nature. A thorough openness for developments relevant to society is imperative.

The competences of a head of a unit/local tax office, of a department and of a team are set out in the following scheme:

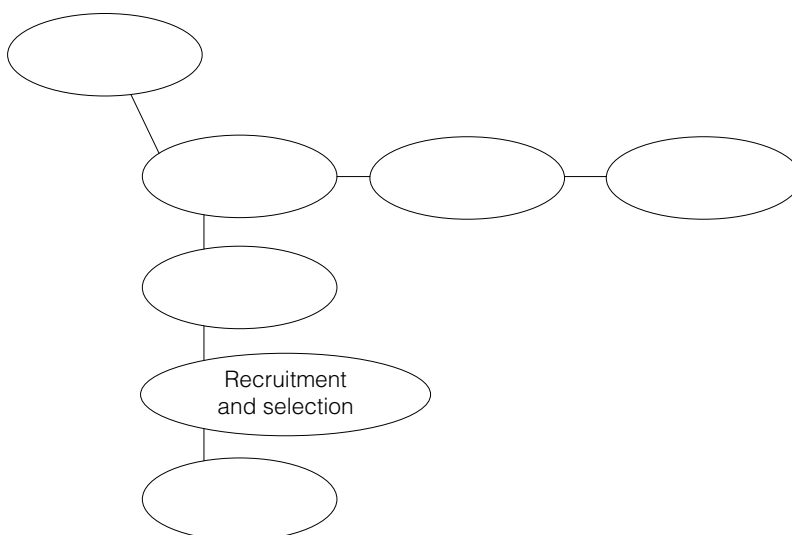
Competences	Head of unit	Head of department	Head of team
To elaborate and shape the central policy framework at the level of the	unit	department	team
To provide feedback and to contribute to the central policy framework at the level of the	central directorate	unit	department
To manage and direct	heads of departments and/or teams	heads of teams	team
To elaborate/to translate into objectives and targets (management performance contracts)	central objectives on department/team level	unit objectives on team level	team objectives on individual level
To inspire and to coach the subordinates of the	unit	department	team

A team manager needs the above competences for managing line activities. Should a team manager also have been charged with functional management tasks, he/she must possess material knowledge in the area of the team.

Increasingly, team managers act as a coach for their team members. This coaching is of a one-to-one nature and is thus directed at the individual contribution of a member to the team. This coaching role requires the team manager to delegate responsibilities to the team members. Ideally, the team member performs and concludes any task delegated and simultaneously develops the necessary skills.

A director of a central directorate must have the competences and skills of leadership in a broad sense. The director must be able, amongst other things, to determine the central auditing policy and to formulate realistic principles for such a policy. These principles must be aimed at completing realistic numbers of verifications and audits, specifying their required quality, the way in which subordinates will be lead and coached, and the training and refresher training activities for employees.

2.3.2. Recruitment and selection of auditing officers



Every Tax Administration will want to have proper insight into its workforce composition and personnel structure, and into its short-term and medium-term needs. The need/demand for new employees within the Tax Administration versus the labour market supply of potential employees are major factors that dictate the Administration's recruitment and selection strategy.

The recruitment effort for new employees is directed both at recent graduates and at employees from other organizations. Recent graduates include those having completed secondary education and those who, after their secondary education, have completed an (advanced) professional training or have graduated from university. The recently graduated offer the advantage that a Tax Administration can train, develop and orient them to the ways of its organization. A disadvantage of this group of newly recruits in comparison with those that have been previously employed elsewhere is their lack of practical experience.

Every organization needs to have a set of tools to help guide the selection process. The guiding principle is “the proper person at the proper place”. A careful and well-considered recruitment and selection procedure is a key precondition; the following procedure and corresponding tools can be successfully used in recruiting and selecting employees for verification and audit. No matter how the recruitment and selection process is organized, there are some general rules that apply to every Tax Administration. Recruitment and selection has to be done on the basis of good procedures, knowledge and competences of the candidates, and not on the basis of the engagement of a political party, belief, family or friendship.

Hence it is very important to organize the selection process in such a way that a very high degree of transparency is attained. A high degree of transparency means open competitions, giving interested parties access to all stages of the process, public announcement of future offers of employment and the requirements to be met by the applicants. The requirements can include admissible restrictions of a legal nature and the minimum qualifications for appointment to the position. Also information about the selection process itself must be public; for example, that applicants will be tested on technical knowledge and that they will undergo a psychological test.

It is not sufficient to have some general rules. It is essential to incorporate in the organization the guarantee that these general rules are applied. This can be done in many different ways. For example, in the United States the system governing selection decisions for all positions within the federal government is based on three tenets:

- recruitment of qualified individuals will be conducted so that the resulting workforce is a representative mix of society;
- selection decisions will be based solely on an individual’s ability to perform the duties of the position; and

- all applicants will be treated fairly and equally, without regard to political affiliation, race, colour, religion, national origin, gender, marital status or handicapping condition.

To that end, open competitions are required to fill all positions within the government. In addition, the selection process is managed and monitored by personnel organizations within the federal agencies and by other agencies. These organizations have the responsibility to ensure the continued integrity of the selection process. In addition, once selected the majority of employees in the federal government work to achieve a career status. Career status is achieved after three years of continuous employment. Such status affords them protection from arbitrary actions, such as removal without a cause.

On the basis of the request for filling a vacancy, the HR function proceeds to prepare open invitations for applications, essentially stating:

- title of the vacant position;
- general requirements of the job, e.g. experience;
- specific requirements of the job, e.g. educational qualifications;
- competencies of the job;
- documents which the candidate must submit;
- application and introduction procedures; and
- selection and hiring procedures.

As candidates apply, it is verified whether they comply with the requirements stated in the announcements so that they may proceed to the process of pre-selection. At this stage, different evaluation tools are applied:

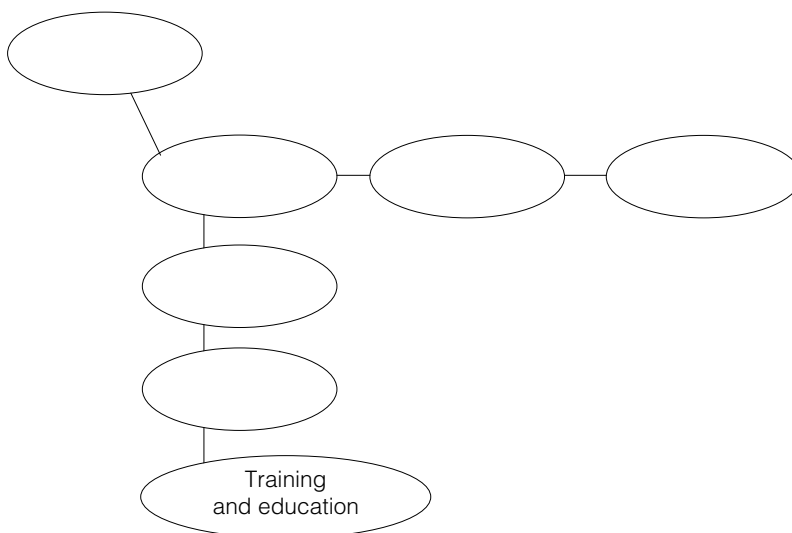
- a general knowledge examination in order to pre-select candidates interested in the study and with some knowledge of what is happening in the Tax Administration and society;
- a psychometric test to measure the intellectual abilities of the candidate;
- assessment centres to measure the behaviour of candidates in situations similar to the job;
- a psychometric test to find out whether candidates have the ability to become career tax officials, have the emotional maturity and restraints to adequately adapt to the working environment of the Tax Administration service;
- interviews with candidates.

Recruitment and training cannot be dissociated. Moreover, they must be linked to the nature of the work to be completed. Determining factors that

will influence the overall approach to staffing the verification/audit function in a Tax Administration include, among others:

- the nature and degree of complexity of the legislation(s) administered: income tax legislations tend to be more complex than sales taxes/VAT. Open economies need a number of provisions to deal with multi-nations and potential loopholes;
- the integration of various taxes: integrated Tax Administrations conduct audit of both income taxes and VAT for small enterprises, under the “generalist concept”, with gradual specialization as the complexity of files increases;
- the culture of the public service administration: the extent to which it positions itself as an employer of choice (including training and development programme), the remuneration system and opportunity for promotion, the recruitment of professionals and security of employment;
- the sophistication of the Tax Administration: computerization, segregation of functions, the extent to which the organizational structure contributes to the development of resources;
- the geography and economy of the country: the size of the country and the need for many offices, management approach to concentration and/or decentralization, general level of education, predominantly agricultural and small enterprises versus urban or dominated by multi-nationals, etc.

2.3.3. Training and education for verification and audit



2.3.3.1. Introduction

Depending upon the organization strategically chosen, employees/officers may operate independently under the supervision of a team manager, or each of the employees/officers within a team may report to the next higher link. Thus, auditing may consist of the following links: auditing assistant to tax auditor; tax auditor to audit leader; audit leader to team manager. With regard to the verification function a series of subsequent links can be distinguished.

The apprentice-journeyman-master model matches the structure in which an employee reports to the next higher link. However, if the concept of a fully independently operating auditor reporting to a team manager has been chosen, the team manager will ask the most experienced members (the masters) to serve as counsel and source of information for experienced team members (the journeyman), who will be mentors to new, inexperienced team members (the apprentices).

The proficiency level to be achieved depends upon the level identified for the specific job. The training required for an individual depends on the previous formal education of the officer, his specific training in auditing

and his experience and attitude and behaviour (tests of individual competence) in practice. Previous training and education can be classified in low/medium, medium, high/medium and advanced/graduate levels.

In all participating countries of the international working group there are two kinds of training: the initial training for new employees and training over the course of the career. The depth and length of the initial training depends for a great deal upon the quality and correspondence of the (university) education that is offered in a country. The initial training consists of different parts:

- basic training/technical instructions (tax laws, verification, auditing, procedures, ethics and discipline, policy aspects, the organization of the Tax Administration and an introduction to information systems and technology);
- practical training: mostly in a function corresponding to the assigned speciality;
- orientation visits to other parts of the Tax Administration.

In some countries part of the training is aimed at the work of the Ministry.

2.3.3.2. Tax Administration values

A Tax Administration must be incorruptible and want to treat taxpayers with respect. The employees of the Tax Administration must exemplify these values by their attitudes, demeanour and behaviour. Obviously, the process in which the employee is engaged affects the desired attitudes. In processes in which the emphasis is on providing service, different attitudes and a different behaviour are expected (taxpayer-oriented) than in the verification and field auditing process (sense on detection). However, the values of the Tax Administration must be demonstrated through behaviour, which must be correct and respectful towards the citizen.

For the Tax Administrations the key question is how to keep the values of the organization alive. Different solutions are possible.

For example, the French Tax Administration has chosen to discuss the theme of professional values with the employees in several seminars. The theme was split up in three sub-themes:

- (1) Contact with taxpayers:
 - ethical values (professional secrecy, integrity, loyalty and neutrality);

- values with respect to the services offered to the public (availability, openness and efficiency).
- (2) Contribution to the community:
 - civil values (equality for taxation, fiscal moral and guarantee of rights);
 - values with respect to professional responsibility (involvement, craftsmanship, responsibility and adaptability).
- (3) Internal functioning:
 - social values (equal opportunities, respect for the individual, solidarity and social dialogue);
 - managerial values (professional dialogue, responsibility, support, acknowledgement and leadership).

2.3.3.3. Continuous learning (e.g. refresher training and continuous training and education)

Even after an employee meets the competences required for their current job, through such activities as a sound formal education, employees must maintain and enhance their proficiency levels of knowledge and skills through targeted (refresher) training courses and continuous education activities. For this purpose some Tax Administrations have established their own training and education organizations, while others have sought cooperation with external training institutes. The immediate superior and the individual employee should discuss on a regular basis the competences to be worked on to help the employee meet the requirements of his current job as well as his future career aspirations. An “individual learning plan” should then be created to list the training (e.g. formal training courses, on-the-job assignments, books to be read) which will assist the employee in acquiring and/or enhancing his competences on an on-going basis.

Tax Administrations are expected to maintain a professional level. To accomplish that, employees must be continuously trained. Therefore, a lot of countries have training programmes for new employees as well as for existing employees.

Tax Administrations have to dedicate a significant amount of resources to the initial and continued training of employees. Offering continued training programmes is not enough to guarantee that employees participate in continued training programmes. Local managers may have a tendency to

postpone educational training in favour of direct production. Therefore, it is advisable to set targets on a yearly basis for all professional employees to receive a fixed number of hours of continued professional education in order to provide a refresher course and to keep abreast of the latest developments. The number of hours needed will, among others, correspond with the complexity of the law and the changes in that law, and developments for example in IT.

2.3.3.4. Training organization

Training must be a very important function in a Tax Administration and is considered essential for any knowledge-based organization to promote efficiency and effectiveness of its employees. It is also one of the most powerful tools to create and maintain credibility and cooperation from the general public. Yet, it is a huge investment that must be properly managed.

As mentioned, the training profiles are the corner stones of a comprehensive approach. A centralized unit must be assigned to forecast and coordinate the needs based on recruitment plans and expected vacancies from the field, and to establish a schedule of courses accordingly. Course material is to be reviewed periodically to remain relevant. A sufficient number of trainers must be trained and available, so that courses are delivered competently and on a timely basis.

A new development of recent years is distance training, facilitated by the use of Intranet. The use of the distance-learning method offers advantages to traditional classroom education. An unlimited number of employees can learn at the time it suits them, and at their own pace. It takes fewer teachers, it cuts down on travel expenses and so on, and it is easier to fit in the normal work for employees.

Many countries have taken initiative to develop programmes for distance learning.

For example, in Brazil the remote training course in tax auditing was developed: more than 2,000 tax auditors were trained in one year. The course was organized in monthly modules and made up of the following components: a study text, exercises, a virtual forum for answering questions and tests. The tool employed permits trainees to take tests upon their request, with a restricted time limit and immediate electronic correction.

The size of field offices may determine whether local training coordinators are necessary as facilitators. It is recognized that some courses will be delivered more efficiently at the local level (based on frequency, immediate needs, complexity of the subject and availability of trainers, etc.).

2.3.3.5. Training profiles as a management tool

Training profiles must be developed for each position. The purpose of the profile is to provide a clear understanding of the training required for each position and to ensure greater uniformity, based on management expectations on the delivery of the programme. Profiles are interrelated, in the sense that they build on one another as an individual progresses in his career.

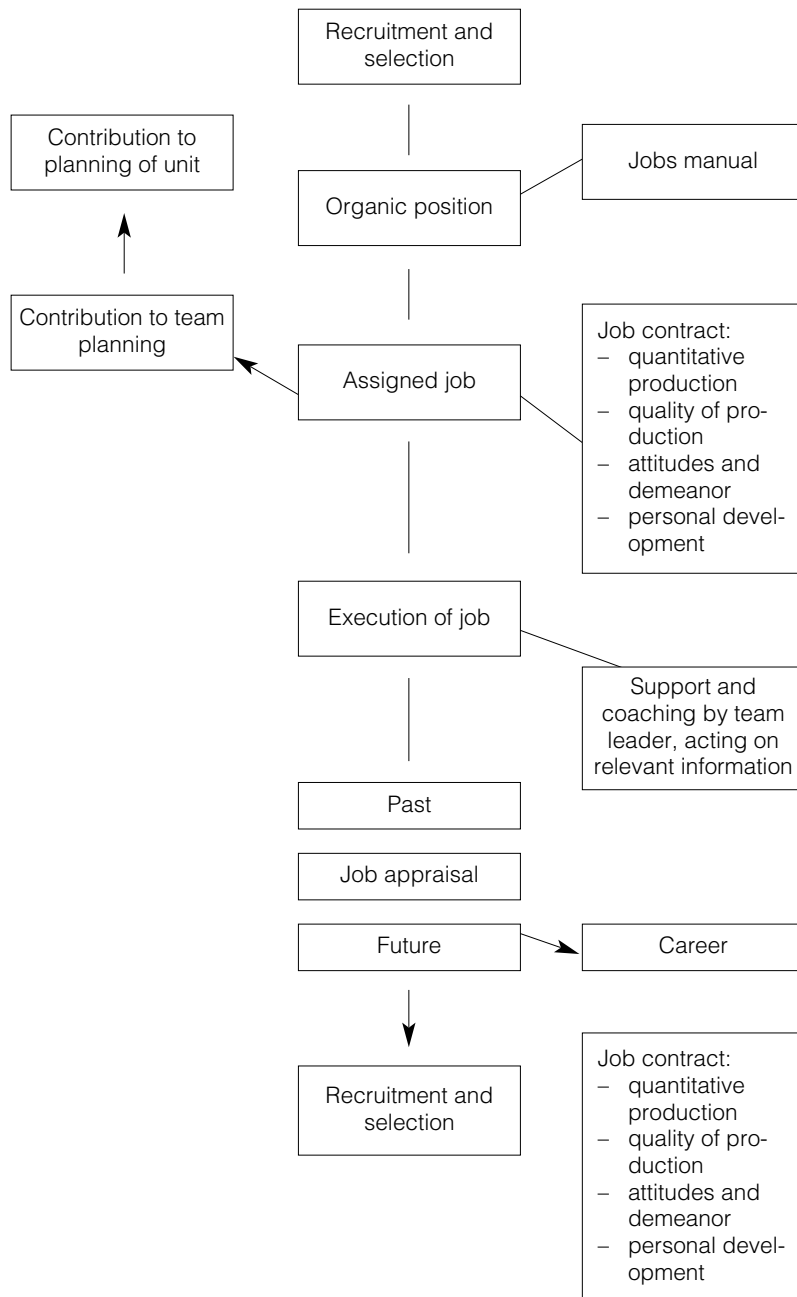
The manager should discuss the specific training profile in an open dialogue with the respective employee and together they should determine which course the employee should receive, and when, based on previous work experience and knowledge. The timing of the exercise is appropriate upon appointment to a position, with reviews done at least annually at the time of performance review.

The job evaluation and performance assessment is a continuing, cyclical process. It must be as transparent as the selection and recruitment procedure.

In Chile, for example, the promotion of employees is based on a competitive system which considers different factors in accordance with each employee's rank. These factors include: precedence within the rank, the time spent at the current rank level, individual performance score and a score based on a technical examination (for management positions) or a written evaluation of technical knowledge (for lower-rank employees). The aim of this programme is to detect the employee's potential and positive attitudes towards work. In other words, they aim to promote personnel that shows the greatest merit, those who display exemplary efficiency and ability. Transparency is guaranteed through the involvement of chartered collegiate bodies of different levels and publication of the factors considered for promotion.

More generally, job evaluation and performance assessment is a continuing, cyclical process, as illustrated in the following diagram:

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Cyclical process

2.3.3.6. Integrated approach for recruitment and training of auditors

Verification is an important corner stone to recruiting and developing resources for the audit function. Recruiting is done either externally or within other functions such as Collection and Taxpayer Services. It allows for basic and gradual training in the income tax legislation and the development of “soft skills” such as communication in a secure and controlled environment.

Appendix 3 provides a typical training profile of a Verification Officer position in Canada, combining formal classroom to on-the-job training over a 12-month period. The profile sets clear expectations both for the managers and employees, promotes consistency of performance throughout various offices, and yet remains flexible to account for individual background and experience.

Audit function

The audit function supports the mandate of the Tax Administration to promote compliance to the tax legislation(s) through a balanced programme of education, service and responsive enforcement. Its role consists of auditing on site source documents, books and records, and income tax returns of all sizes of enterprises.

Recruitment can be done internally and externally. Internal recruitment is a synonym for closed recruitment. Open recruitment means that everybody can apply for the job, whether they are already employed by the Tax Administration or not. However, as the function is committed to a professional organization, the educational entry level becomes more restrictive in order for the staff to enter an appealing career path, minimizing chances of blocking positions by the (academic) inability to move up the organization and to remain motivated and challenged. The minimum requirement is a university degree in a business-related field with appropriate education in accounting (or near-completion) or a professional accounting designation.

National competitions: These processes have the advantage of being quite efficient, as they can handle a large number of applicants with limited resources. For example, a single marketing campaign throughout universities of a country at a fixed time of the year, such as prior to spring graduation, may save much time and energy from local offices otherwise repli-

cating the same process. A coordinated approach to training is facilitated once the recruits are coming in. In addition, it opens the process to various markets, where openings may not exist at a certain location, yet much talent can be recruited from other parts of the country where the economy is not as dynamic at the time, and recruitment is made easier. It also provides more consistency and transparency, and is a good instrument for facilitating the hiring of under-represented groups (equity/positive action programmes). Another advantage of a national competition is that equal chances are offered for a governmental job to every qualified citizen.

Local competitions: By definition, local competitions are more reactive, yet more responsive to immediate demands. They also reflect the needs and familiarity with the geographical area. However, they need to be supported by national statements of qualifications to promote transparency and training profiles to ensure similar standards of performance and service throughout the country.

Open or external recruiting can be done:

- Nationally (one or more times a year). The advantages of a national competition are:
 - tap on the widest selection of candidates, regardless of regional economies at the time;
 - it provides greater transparency through national standards being applied and offering opportunities to all residents;
 - massive and centralized training is more efficient and economical; and
 - it will facilitate staffing from targeted groups.
- Regionally or locally. The advantages of this approach are:
 - the method is more responsive to quick and immediate needs;
 - the training will be centred on immediate local needs. Yet, through a planned centralized training programme the central office can reserve seats for such recruits throughout the year for courses managed and/or delivered more efficiently in a single location.

2.3.3.7. Organizational structure: facilitating training

The organizational structure of a Tax Administration is the result of many factors: culture of the country's public service, financial resources and

expertise available, sophistication in terms of segregation of functions and alignment with its taxpayer base, etc. A comprehensive approach to training will ensure that there is not only a responsible centre dedicated to this function, and that training profiles are developed and followed, but that the organizational model promotes and facilitates the development of its most important asset, the human resources.

Countries have organized their training programmes in many different ways.

Canada offers an example of an integrated approach. Canada integrates the organizational structure based on taxpayers and complexity of accounts with progressive training of staff, as a natural career path while mixing both formal and on-the-job training.

Small enterprises audit (SBA)

The SBA is responsible for conducting audits of income tax returns of self-employed individuals, small enterprises (individuals and corporations) as well as partnerships, with gross revenues up to CAD 15 million.

Characteristics: This constitutes the bulk of the taxpayer population. A risk assessment approach is taken to better identify non-compliance. Records are unsophisticated, with no or limited internal controls, with effective management control generally exercised by one or a few individuals. The focus is on education and visibility as a deterrent measure for non-compliance. A large segment of the audit activity relates to the underground economy, where indirect tests and the net worth approach form the primary basis for identifying underreported income. This is also the entry level in Audit, where much of the formal and on-the-job training is provided.⁸

Medium enterprises audit (MBA)

This section deals with taxpayers with a revenue range of between CAD 15 to 250 million.

Characteristics: Due to the size of the enterprises, the accounting system is progressively more sophisticated, computerized, with internal controls including segregation of functions, access to tax expertise, and audited financial statements. The operations tend to be more stable, possibly with

8. In Canada, more than 12% of the officer's annual time is devoted to training at this level, which includes three grades, from Audit Officer to Auditor (professional category).

two or more business lines and more locations, with possibly some international transactions and increasing tax-planning sophistication.

The professional auditor relies on a number of years on the job, having been exposed to a variety of accounting systems and dealt with many sectors of the economy. While, generally speaking, still a one-person audit, the auditor has access to specialized areas on demand (international, tax avoidance, e-commerce, industry specialists, etc.).

Large enterprises audit division

This Division manages the compliance relationship of the largest corporations of the country (CAD 250 million or more).

Characteristics: The large enterprise community offers both challenges and opportunities for a Tax Administration:

- elaborate organizational structure incorporating functional (management or corporate services);
- horizontal and vertical integration;
- complex domestic and international transactions with non-arm's length parties (international) transfer pricing;
- extensive use of tax practitioners capable of aggressive interpretation of legislation and complex tax rulings;
- controlled entities served by many local offices in the country with potential for inconsistent tax application and significant impact on government revenues.

With the increasing size and complexity of enterprises to be audited, it is no longer reasonable to expect a single auditor to possess the level of expertise required to conduct efficient audits. Modern Tax Administrations have adopted the concept of "account executive", an experienced professional auditor managing the audit of an entire conglomerate through a team audit approach. A group of business auditors is part of the team on an on-going basis and becomes familiar with a specific file/sector. A comprehensive audit plan is designed through the contribution from specialized areas, as full team members, such as: international tax experts, tax avoidance, information technology or industry specialists and, on a need basis, business equity evaluators and real-estate appraisers or other multi-disciplinary specialists.

Appendix 4 presents a typical training profile covering the wide range from verification officer till auditor with the largest enterprises. In

Appendix 3 a simplified version of the Canadian Auditor Recruitment and Apprenticeship Programme is presented.

The above-mentioned structure allows for the account executive to be primarily a team manager, surrounded and supported by the required technical expertise.

2.4. Planning and control

2.4.1. Introduction

Tax Administrations will want to manage their various processes (including tax auditing), both quantitatively and qualitatively, by means of a system of planning and control. Through planning and control a Tax Administration aims to ensure the integrity of its operations, and to contribute to the equality and the security before the law, as well as to justice.

Where the various responsibilities are located has been pointed out earlier. Directors of divisions, heads of units and team managers are responsible for the planning and the fulfilment of the management contracts. Thus, they will translate the contracts agreed upon into plans, and then monitor and control their execution in both quantitative and qualitative terms, or have it monitored and controlled. Planning and control have their foundation in an effective system for planning, reporting and accountability.

2.4.2. Planning

The responsibilities of the director of the central directorate include the determination of the central enforcement policy. This policy is reflected in policy plans (usually covering a period of five years) and the annual plans derived from it. Directors of regional directorates and of divisions are responsible for the determination of policy and annual plans of the directorate or division, and for their execution. Head of units are responsible for the unit plan and its execution; team managers for their team plan and its execution. Finally, each employee is accountable for his personal contribution to the realization of the team plan (see also Appendix 5).

Any arrangement with regard to the realization of annual plans and the conditions under which they must be achieved should be laid down in

management contracts, notably: management performance contracts of the director of the central directorate with directors of divisions; directors with the heads of units; heads of units with team managers; and team managers with individual employees.

Note that the performance contracts must also include or have a direct link to budget letters.

It is important in this process of planning to communicate to the employees the objectives to be achieved by the organization as a whole, including the expected contribution of the employees. This communication should not only accompany the annual plans, but the management should make use of every opportunity. For instance, in publications in the media (internal or external) about the Tax Administration, the mission, objectives and values must be underlined. Also, the organization as a whole must behave according to these guidelines. The communication must also clearly set the boundaries: what is it that the organization explicitly does not want to be done. Besides publications in the media, all opportunities to communicate the objectives to the employees must be used. For example, varying from visits by the top management to local offices to the annual performance review.

2.4.3. Control

Control is the process which ascertains whether, and to which degree, objectives are being achieved (in terms of efficiency and effectiveness), and which risks are being encountered. As part of the control, process advice – invited and spontaneous – is given on the necessity of adjustments. Those who are accountable for achieving the objectives (in almost all cases this will be the management of the Tax Administration) must make these adjustments.

In order to improve the control of the process in France a diagnostic action programme has been developed:

Every year, the central directorate for auditing assesses the goals for the auditing programme and surpasses the goals to each auditing directorate. This diagnostic action programme is an instrument to support the dialogue between central directorate, directors and office managers. The guidelines of the programme consist of the following elements:

- a global diagnosis of tasks and means;
- analysing the performance and accomplish possible margins of progress;
- establish clear and realistic priorities;
- evaluation of actions.

The action programme itself consists of a more detailed elaboration:

- specific guidelines with respect to the priorities, including a time scheme, which are interrelated, tuned to the means and supplied with a measuring instrument;
- assessment of the necessary actions (organization, working methods, the use of means, supportive measures, training, cooperation in solving non-audit-problems, consultations together, means of communication);
- organizing the execution of the actions, by distributing the goals assessed on the central level to the lowest management level in the organization, including the necessary means.

To manage the process of enforcement the control function is an important instrument. Before discussing the control function it is good to define who the stakeholders to the Tax Administration are. Several stakeholders can be distinguished:

- politics (parliament and ministers);
- international organizations;
- judiciary;
- tax consultants and accountants;
- opinion: media and science;
- taxpayers;
- employees;
- government audit office;
- other government bodies.

The control function must not only be aimed at the internal functioning, but also at the expectancies of the external stakeholders. For example, not only the figures on effectiveness and efficiency, employee satisfaction, rate of illness, etc. are of interest, but also, from a financial point of view, the figures on the amount of taxes collected, the actual costs (budget) and the amount of taxes unpaid are of interest. Also, what is the opinion of the taxpayers, their consultants, the media and science about the functioning of the organization. Moreover, there is a need for insight in “consumer satisfaction”, was there negative publicity about the Tax Administration, were there many complaints, etc.

According to Simons' *Levers of control*,⁹ a distinction must be made between the more diagnostic (mechanical) control mechanism related to critical performance variables and interactive control systems related to strategic uncertainties. The diagnostic systems result often in critical success factors and performance indicators to measure the performance. Diagnostic systems are internal oriented and make use of figures available within the organization. Interactive systems are more external oriented and comprise tools such as a customer panel or review, the use of operational audits to highlight certain aspects of the operations, benchmarks and more in general the use of reviews.

An example of a review is used by the Internal Revenue Service in the United States:

The Quality Measurement System (QMS) measures and evaluates the quality of the tax examinations conducted. A statistically valid sample of cases is reviewed to insure a high level of quality, consistency with tax laws and adherence to auditing standards. Data derived from the reviews is used to provide feedback to management, improve customer service, provide an analytical tool to improve examinations, identify training needs and to increase the consistency of examinations.

Within the control function various levels and perspectives can be distinguished:

- strategic, management and operational control; these forms of control are particularly aimed at outputs;
- process control, directed at the various functions that can be distinguished, such as collecting, validation, verification and auditing;
- financial control, which is directed at the financial function and which monitors transactions and flow of money;
- quality control which complements the equally important quantitative control.

Control may be further segregated into:

- hard control (statistical output), and this is controlling on the basis of figures;
- soft control (attitudes, demeanour and behaviour).

An aspect that requires continuous care and attention is integrity. The nature of a Tax Administration's organization causes its employees to be

9. Robert Simons, *Levers of control* (Harvard business school press, 1995).

in immediate contact with money, goods and flows of goods, and with the large financial interest of enterprises and private persons. In these contacts tax officials must remain objective and incorruptible. The organization must provide guarantees in this respect.

2.4.3.1. Developing the control function

A certain development in the role of the control function emerges, in which a number of stages can be distinguished. It should be pointed out, however, that these stages depend upon the developmental state of the organization itself with regard to the processes (internal focus versus taxpayer-oriented focus), the technology (separate systems versus integrated systems) and the organization (bureaucratic or entrepreneurial).

Decisive in this respect is which controlling role the management sees for itself.

An example of the way a central directive is translated to the local office is the work of the teams of the *Direction Générale des Impôts* in France.

Their work is characterized by the decentralization of tasks and means in relation with increased responsibility for adjusting choices and decisions to the local context. This policy is based on steering by goals and an extensive dialogue concerning the management policy. The policy goes along with internal control measures to guarantee the quality and reliability of the work performed. This includes the correct application of tax laws and directions, managing the risks of safeguarding computer information, securing the safeguarding of persons and goods and applying ethical values.

The internal control is in first instance performed by the manager of the audit team and in second instance by representatives of the directorate. The internal control concerns:

- the safety of the auditor (for example resistance against the auditor, threats, theft of material or information);
- professional ethics (behaviour, responsibility, acting according the own rules and obligations);
- organizational risks in relation to the audits (planning, legalization of appeal documents, audits on the spot, fines, collecting, treatment of disputes).

2.4.3.2. Scorekeeper

In its most elementary role controlling involves keeping a clear tally of all transactions taking place within the organization. Examples of items determining the score are: invoicing, purchase, salaries, production records, etc. The controller who fits to this stage is thus typified as a “scorekeeper”. This name also reflects his focus: recording scores. As long as these scores are properly and reliably kept, management is considered to be appropriate.

2.4.3.3. Financial controller

In a more advanced development stage the scorekeeper develops into a financial controller. In addition to his investigation into whether scores are kept properly, the financial controller checks whether this is also done efficiently: it must be proper and fast. The focus of the financial controller is both on scores and the various reports on the basis of these scores. At the same time he checks whether all this is done at the lowest costs possible. Cost awareness of one’s own activities and those of others is highly developed.

2.4.3.4. Management controller

Still a stage further in the development is the management controller. The systems, routines and procedures through which scores are kept, are at their proper place; they are reliable, and their efficiency is regularly critically reviewed. The management controller, though, brings in some new skills and perspectives. The focus of the management controller is on the manager, who he sees as a customer to be served by, first of all, listening and understanding his requirements and trying to anticipate his needs. This type of controller does not answer questions solely by producing figures, but also by providing an opinion based upon relevant information. He will assist in preparing projections, will be involved in budgeting, and will blow a whistle if budgets are exceeded. The management controller has the ambition to be “a partner in business”.

2.4.3.5. Quality assurance

Here, the notion of quality assurance is extended to planning and control. In addition to what has been said on the role of the control function and

that of the controller, quality within the planning and control framework is assured by:

- assessing work done by or on behalf of the team manager;
- assessing work done by technical experts;
- supervision of most experienced employees (mentor);
- supervision as part of coaching;
- supervision within specialists groups.

An example of the last bullet can be found in the Netherlands: the auditing coordinator.

In each local office/unit of the Tax Administration of the Netherlands, for each process, including the process of tax auditing, an officer has been appointed whose duty is to ensure and enhance the quality of the activities in respect of that process. This officer functionally manages a group of employees who are experts on tax auditing in that local office/unit. In that capacity, the officer is responsible for:

- conducting the “heaviest” audits;
- internal control in order to measure the quality of audits carried out by other tax auditors in the office/unit;
- preparing proposals to enhance the quality (for instance, through training and education, or through organizational change);
- coordinating the implementation of new audit techniques;
- coordinating the implementation of new laws and regulations.

He also serves as a point of contact and counsel for other tax auditors who are confronted with complicated issues.

CHAPTER 3

RISK MANAGEMENT AND THE RELATED TREATMENT FORMS

3.0. Summary

The main aspect of Chapter 3 is the context and framework of risk management. “Risk management” can be defined as the systematic process in the course of which people and resources are deployed, based on risk analysis aiming to achieve an optimum result. In this chapter the steps necessary in such a process are described.

But risk management cannot stand on its own. There is a crucial interrelationship between risk management and the treatment strategy. This interrelationship leads us to the forms of treatment, which will be discussed in this chapter. Firstly, the proactive activities (actively providing information and proactive up-to-the-present testing) and, secondly, the reactive/testing activities (validation, verification and audit). Risk management and the forms of treatment mentioned above will have to tackle the filing gap, the collection gap and the non-correct filing gap.

However, before these gaps can be tackled, one other gap will have to be dealt with. This is the non-registration gap. It is essential that all taxpayers are registered completely and correctly. So the first part of this chapter will deal with this gap.

3.1. Introduction

Law enforcement consists of three components: the interpretation and execution of the law, examination and providing services. The verification and audit process is part of the component “examination”.

On the one hand, the enforcement of the law must meet all requirements of equality before the law while, on the other hand, for reasons of effective and efficient performance of their duties, the Tax Administration must make choices with respect to the degree of examination. This means that the execution must be business-like and based upon rational arguments,

and must not be arbitrary. Making choices equates with the selection policy. The selection policy rests upon risk management.

However, before we are sure that the selection policy is in accordance with all requirements of equality before the law, we have to be sure that all taxpayers are in our database. The first, essential step is to register all taxpayers completely and correctly.

3.2. Basic information; registration of all persons liable to pay taxes; the master file

3.2.1. Introduction

To a large degree the Tax Administration depends upon a reliable and complete database of the taxpayers. This database can take two forms: digital and physical in the sense of paper files and dossiers. The sophistication of the technology used varies from country to country. This affects the extent in which information is available in digital form: from a simple database of taxpayers to complex database structures using exclusively digital tax returns. The size of the physical dossiers is inversely proportional to the level of sophistication. This chapter will not deal with the requirements for safeguarding physical and digital systems.

3.2.2. Contents of a database

The contents of the files of the Tax Administration itself includes names, addresses (occasionally the same taxpayer has more than one), bank accounts, etc. These data establish the identity of individual taxpayers. Historical data, such as former addresses with their date of change, should also be retained and available for a number of years. For this, separate provisions must be made: (i) digitally, in the form of historical data fields, and/or (ii) physically as mutation lists. Procedures to (the competence of) change these standing data must be established and be supervised adequately. In order to avoid irritation and errors, there should be only one basic database that governs all derived databases and files.

In many countries, agreed links have been made with external databases, such as those for the civil data of municipalities, databases of the Chambers of Commerce, of social security agencies, health insurance organizations, etc.

It is very important to have unique permanent identification numbers, because:

- much of the data of the taxpayer will change (for instance the address) but the identification number will be permanent;
- there can be no misunderstanding which taxpayer is concerned;
- all available information and data of the taxpayer can be linked to this unique identification number and can be the key to get the information and data in an easy way;
- it is easy for the communication between the Tax Administration and the taxpayer;
- the identification number can be the link between different databases.

A database may contain the following data:

- data on the liability for a tax instrument;
- data on the processing of tax returns;
- data on tax returns received: information about the composition and the level of amounts declared;
- historical data about tax returns and other behaviour in the past;
- signals and indications for treatment and selection generated by the Tax Administration itself, both up to the present and in the past;
- data on tax assessment imposed, provisional tax assessments, supplementary or additional tax assessments, adjustments, correspondence, decisions on fines, verification of payment of these fines, etc.;
- data on the tax assessments imposed, as well as on the flow of payments by the taxpayer;
- data on the taxes a taxpayer has to pay.

Actively signalling the existence of a tax liability is one of the duties of enforcement, also there where persons have the obligation to register at their own initiative. The signals for registration (the signals for the registration as well as the registration itself) must be included in the basic database correctly and completely. These data are the starting point for the subsequent administrative process.

Data on the processing of tax returns

By which date can tax returns be expected? Are they in time? Standing procedures for late tax returns and/or missing tax returns. Progress controls initiate actions of the Tax Administration such as sending reminder letters, imposing fines, etc.

Data on tax returns received: information on the composition and the level of the amounts declared

In addition to this information, the tax return may include data that can be used in the selection process. For example, information on the profession of the taxpayer will not have direct consequences for the level or composition of the amounts, but it does constitute a distinctive item for the risk selection. Fiscally relevant financial disclosure items also belong to this category. For instance: Has the valuation system for stocks been changed? Has the taxpayer made use of a tax credit? If so, for what amount?

Historical data on tax returns and other behaviour in the past

The past performance of a taxpayer can be an important factor for the risk selection. From various studies it appears that “wrongful” behaviour in one area is a useful indicator for “wrongful” behaviour in other areas as well, including the area of taxation. See also section 3.3. of this chapter.

Signals and indications for treatment and selection generated by the Tax Administration itself, both up to the present and in the past

It is important that each treatment, assessment and decision results in an audit trail, i.e. a trail that can be traced and backtracked later. Depending on the technique, various opportunities for creating such a trail exist: notes by pen, name stamps, block stamps, sheets for notes in a fixed format, digital forms of such sheets.

Data on tax assessment imposed, provisional tax assessments, supplementary or additional tax assessments, adjustments, correspondence, decisions on fines, verification of payment of these fines, etc.

Each system must include guarantees that tax assessments are indeed imposed, that these assessments are in conformity with the data, that any digital or manual procedure results in adjustments, and that these adjustments are implemented. All this must be verifiable afterwards.

3.2.3. Completeness of database of taxpayers

The Tax Administration has to be sure that the database of taxpayers is complete. Several measures can be taken to deal with this issue, such as:

- proper legislation: give persons the obligation to register themselves at their own initiative;

**Basic information; registration of all persons liable to pay taxes;
the master file**

- easy procedures for citizens to register;
- link with external data bases;
- active activities aiming at the completeness of the database.

In some countries, even for each district a separate department has been created, aiming at the completeness of the databases and files. The departments may be called Active Service, Operational Control, etc. In fact, their job is to identify the real forms of enterprise in various locations and districts, to compare their observations with data in the databases and files, and to signal any differences found to other departments. Areas of special attention, geographically (which districts), tactically (which industries, which minimum sizes of business activities) and strategically (rules of conduct for tax officers) must be designated at a higher, common level. An observation department that is well organized and appropriately embedded in the organizational structure has proven to be valuable to the proper functioning of a Tax Administration. Also, its work appears to be of great value for the acceptance of taxation by society (principle of equality).

The very opposite of this issue of data collection is the problem area of identity fraud. Often, a fiscal registration number is issued which, in some countries, is linked to other functionalities, such as social rights and obligations, medical insurance, education, etc. In countries with a high degree of administrative integration, this creates the risk of “identity fraud”. In the eyes of citizens, inclusion in social life, elementary civil rights, social security, and the right to work are opened to them only by having been assigned a multi-functional registration number. Having such a registration number may become a goal in itself and an effort may be made to obtain such a number by using false identity papers, or by “borrowing” the number of another person. Occasionally, one registration number is used by ten or more individuals. This is an important issue, because in this way wrong information and data are linked to a specific identification number and will lead to a wrong levying of taxes.

3.3. Risk management, the context and framework

3.3.1. Introduction

Establish the context

“Risk management” can be defined as a systematic process in the course of which people and resources are deployed, based on risk analysis aiming to achieve an optimum result.

The risk management process is normally a continuous process. This is necessary because the process must be effective within the environment in which the Tax Administration operates. This environment is subject to change, and these changes in the environment will have an effect on risks and risk assessment. Such changes could be of a various nature, such as market changes resulting from new technology (e.g. the Internet), technical changes, etc. These changes may create new risks or necessitate reconsidering existing risks.

Analyses will have to be made to minimize any damages and to maximize any benefits. Thus, the risk management process involves not only operational decisions, but also requires the commitment and high-level decisions of senior management. Such decisions will be on questions such as: how to adjust the organization to the principal fields of attention, and how to allocate resources (both human and technical).

The continuous feedback from the risk management process will also help senior management to set aims and objectives for the overall tax control process, to work out control plans, to allocate budget resources, and to refine decision-making processes in these areas. Feedback can also be of great importance at the political level in formulating strategies for the future.

By using risk management techniques, human and other resources can be deployed in such a way as to achieve an optimal balance between law enforcement and support to taxpayers.

The feedback from evaluations also enables management and the operational level to be more proactive in the control field instead of taking a reactive stance. In addition, it will enable intelligence units to improve the identification of antifraud measures, and to implement them timely.

There are many benefits of a risk management process, of which the principal ones are:

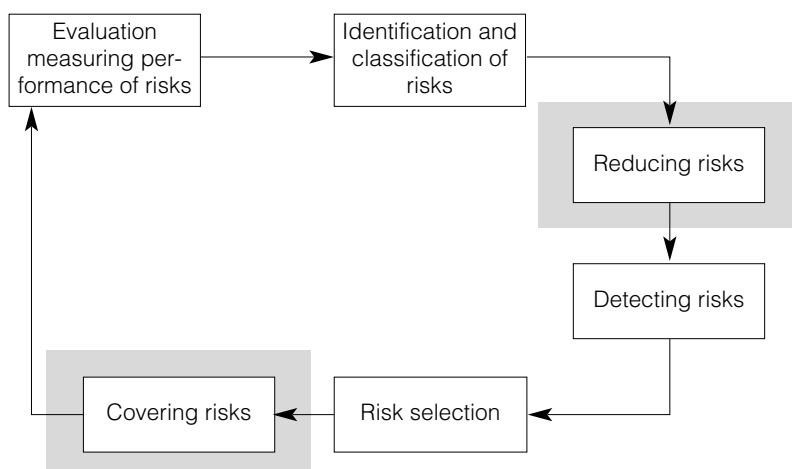
- equal treatment and public confidence;
- possibilities for central target setting;
- the ability to match resources and risks;
- effective strategy decisions;
- it relieves compliant taxpayers from the burden of a tax audit;
- it improves the use of resources leading to better results;
- it allows work to be carried out more systematically;
- it creates improved possibilities for communication and cooperation;
- decisions will be based on analysis following a scientific approach;
- reviews of various measures of influencing compliance behaviour;
- alternatives for reducing risks and the relationship between the alternatives;
- risk analysis and the use of resources to achieve an optimum implementation of the law.

Risk analysis is the key to the risk management process. It can, in principle, stand on its own, but the full benefits of risk analysis can only be gained within a structured risk management framework.

Risk analysis is a proactive and dynamic process through which risks are systematically identified, analysed and assessed, so that it provides the basis for decisions on further actions. It also monitors and reviews the development of risks through measuring taxpayers' compliance.

3.3.2. Risk management framework

Because of differences in legislation, administration and organization no common framework exists. Nevertheless, the following model identifies steps that are necessary in such a risk management process:



3.3.2.1. Identification and classification of risks

The first step that needs to be made for risk management is identifying and classifying the theoretical object risk, and the related fiscally relevant facts and events. For each fiscally relevant event and fact must be established which object risks it creates with regard to various tax instruments. A fiscally relevant event or fact can create object risks with regard to several taxable tax instruments. The objective of this stage is achieving maximum completeness. Failing to identify and classify risks properly has an impact upon subsequent stages, and ultimately risks will not be covered.

Studies of phenomena

Examination activities can be carried out for research purposes. This is research into an economic phenomenon, such as a new line of business or industry, increasing the knowledge of existing industries or of a current auditing instrument. Characteristic of this research is its uncertainty, preventing predictions to be made, lacking efficient procedures and making it necessary to try out different routes and methods in order to find out what does work, and what does not. These uncertainties added to the need of experimentation make research of phenomenon require much time and capacity, proper planning and progress being monitored.

This research consists of the following steps: recognizing the need for research, formulating the terms and objectives of the research activities, roughly planning the capacity, extent and time required, obtaining

approval, selecting suitable taxpayers and tax researchers/auditors, assigning jobs, carrying out procedures, making interim evaluations and reporting and preparing the findings.

As an example, the methodology that is used in the Netherlands for identifying and classifying fiscal risks of individual industries and lines of business:

Taxpayers active in the same industry or line of business often have similar trends in terms of their occurrence and opportunities, or lack of opportunities, to detect and to tackle them. Some industries offer better opportunities for keeping relevant facts out of sight of the Tax Administration. Moreover, “standards and values” may vary substantially from business to business.

The methodology has been structured so as to link (virtually) all industries to a particular target group. A team of tax officers is assigned to each of these target groups. It is the duty of the tax officers assigned to a specific target group to establish, test and maintain its industry description, to exchange knowledge and experiences with regard to industry-specific issues, and to act as an internal knowledge centre to the entire Tax Administration. Obviously, these tax officers have an important role to play in identifying and classifying risks; they are responsible for elaborating and analysing the risks of their industries.

The Tax Administration of the Netherlands distinguishes the following target groups:

- agriculture and fishery;
- construction industry;
- hospitality business;
- trade;
- motorcar distribution and repair;
- transport and warehousing;
- commercial services;
- medical services;
- personal services;
- manufacturing;
- financial services;
- not-for-profit organization services.

This methodology provides an improved insight into categories of companies/taxpayers. By concentrating this knowledge in a limited number of

employees and by gathering, recording and disseminating this knowledge systematically, the insight in and examination of fiscal behaviour (including the situation, the risks, their motives, etc.) of certain groups of taxpayers is improved. In addition, the industry-oriented approach supports the effective treatment that upholds the equality before the law and therefore has a neutral impact upon competition (see the paragraphs on detection and selection hereafter). From an external point of view this methodology makes the Dutch Tax Administration more easily accessible for groups of companies/taxpayers, as they are usually organized according to industry. The approach creates, for instance, opportunities to make certain agreements with trade or industry organizations (within the scope of the law).

Finally, the industry-oriented method of operating facilitates the gearing of supporting services to the need of the tax officer. Because jobs and tasks are assigned to employees partly according to industry, the training, provision of information and instructions can be fine-tuned to the needs.

In France the identification and classification is dealt with in an other way:

The services in charge of the investigation and research (1,200 agents)

Cases to be examined are selected, in principle within the framework of control, on the basis of documents. However, this type of control does not allow for detecting the totality of issues requiring an external fiscal control. In some cases, other means are required. The search for information is an important element of the effectiveness of external control.

Structure

At the national level:

- *The National Directorate of Fiscal Investigations* (DNEF, acronym in French) exercises, for the benefit of all the services participating in fiscal control, a mission of investigation, centralization, processing and diffusion of information, whether it is the case of specific data to directly support the programming or data of a documentary nature for providing the examiners methodological information. If there is any suspicion of fraud, the DNEF may resort to the examination and seizure procedure, under the examination of a judge.
- *The National Economic Investigations Brigade* (BNEE). The agents of this Brigade provide technical support to the Judicial Police within the framework of its struggle against financial delinquency.

At the interregional level:

- *The Studies and Programming Brigades* (BEPs) are under the direct authority of the division Director in charge of fiscal control of the Interregional Directorate of Fiscal Control. Its role is to appraise the information and determine the programming of external fiscal control, coordinate the investigation actions at the interregional level in collaboration with the SDRs (French acronym equivalent to Documentation and Investigation Sections).

At the local level:

- *The control and investigation brigades* (BCRs) are established in each Tax Service Directorate. They have as correspondent in each Interregional Directorate the unit that constitutes the BEPs. Its mission is to seek information for programming the external fiscal control.

Fiscal procedures

The DNEF is in charge, under the control of the judge, of establishing the visit and seizure procedures required to discover the material evidence of the most serious fraud cases, in coordination with the BCRs, by means of the action of the BII (Interregional Intervention Brigades) and the BEPs at the interregional level.

Within the framework of the right of communication, they obtain from third parties useful documents for the calculation, control and collection of the tax. This right of communication is also available to the BCRs and BEPs.

Investigation services are also empowered to investigate businesses, in order to detect violations to the invoicing and invoicing obligations that must be fulfilled by taxpayers subject to VAT. This procedure allows for unexpectedly intervening among taxpayers. If irregularities are observed on such an occasion, they will result in a subsequent examination of the accounting records.

External contacts

In keeping with their mission, investigation services work in coordination with the other Directorates of the Ministry of Economy and Finance (customs, jurisdiction and consumption). They maintain relationships with the police in order to compile useful data for fiscal control. They also exercise the right of communication before the representatives of the General Attorney's Office, the courts, regional account chambers and all government services.

In Argentina there is a country-wide economic area-based tax inspection unit at the central level that is responsible for performing studies related to industry to identify business areas with more potential for tax evasion, detect tax evasion gaps, ascertain their mode(s) of operation, reveal the main causes leading to this evasion and design mechanisms to reduce or counteract such tax evasion. This process is described in detail in a procedure manual that is distributed to the rest of the organization so that it can be implemented in other inspections carried out on the respective cases.

By way of an example, we mention the steps involved in this type of process that are carried out by tax specialists and by professionals with experience in the business being analysed:

- (1) Identify the most important economic sector in terms of evasion potential, for instance by measuring the input-output ratio and identify activities which – based on internal experience in the operating area or formal complaints received by the organization – are known to be prone to evasion.
- (2) Once this group of taxpayers or business areas specifically linked to a certain economic activity is identified, a comprehensive analysis is carried out of the tax and social security regulations linked to the industry.
- (3) Surveys, queries and interviews are carried out with organizations representing the industry. Often the industry organizations themselves are our allies in this issue because they are seeking greater accountability in their own market.
- (4) These multi-disciplinary groups provide technical training courses related to the activities that are analysed. (This involves using government or private organizations that are related to the business area under consideration.)
- (5) Once the possibility of tax evasion is identified, field tests are carried out, i.e. tax inspections by the same group who did the previous work. These pilot tests constitute an essential basis for underpinning the work.
- (6) Finally, both the work and the experiences are laid down in a written document drawn up by the inspectors involved in the preliminary study. This procedure manual is then distributed in the rest of the organization. Furthermore, a training course or technical workshops may be held where the inspectors who participated in the industry study explain their experiences to the rest of the organization.

This type of approach enhances the inspector's work and builds the agency's image with taxpayers, who can observe that the inspector has

prior knowledge of their business and will obviously gain respect for the tax agent's actions. As a result, the tax agency will achieve greater success in its attempts to reduce existing levels of tax evasion.

Generally speaking, the policy of the federal Brazilian Tax Authority clearly defines the limits between the planning activity, which consists of selecting who is going to be inspected, and defining what has to be submitted to the audit, and the inspection activity itself, which has to proceed with the examinations in an efficient and technical manner, without escaping the previously defined objective.

Analysis of the risk of change in Brazil

The risks for tax collection occur practically every day. Some small change that impacts on the economic activity or on the mood of the economic players can affect the Tax Authority; but also legal decisions or new laws are examples of risk factors. In the case of the Brazilian concept, there are six major factors for dealing with risk:

- (1) It is necessary for the people who make this type of evaluation to know the Brazilian tax system in depth.
- (2) It is necessary for this group to be aware of all kinds of internal and external financial information, reports and data, which might affect Brazilian economic activity.
- (3) The persons involved must observe changes in legislation and legal decisions on tax issues.
- (4) The Tax Authority must have information systems with data that are as up to date as possible in order to be able to simulate the impact of any change in tax collection and possible corrective measures.
- (5) Once in possession of the information, and knowing its impact, it is necessary to have the capacity to propose ways of preventing the change from occurring or know how to overcome it if it does, in order to avoid tax losses.
- (6) When the change has occurred and measures considered adequate by the Tax Authority have been taken, it is necessary to monitor the results to evaluate the action and any corrections.

The two crucial points for effective monitoring of the risk are the education and training of the officials involved in this activity and a system that allows fast and reliable risk analyses and simulations.

The federal Tax Authority is continually trying to promote the training of its officials working in this area, being aware of the complexity and the difficulty of training qualified personnel. The measures range from short

internal and external courses to releasing officials to attend post-graduate courses in Brazil and abroad. The official working in risk analysis must be well trained and informed, as well as being capable of proposing alternatives to adverse scenarios.

The use of adequate information systems is also another strong point of the Brazilian Tax Authority, which has the Spreadsheet Generation System (SGT), with access to all the income tax returns of private individuals and bodies corporate since 1996, the latter group being divided into SIMPLE, Presumed Profit, Actual profit and Immune and Exempt (see also section 4.1.2.1.3.). The software is structured to allow fast access – in a few minutes – to all the fields of these returns. It is also possible to accumulate data per state, district, economic activity of the taxpayer, size of turnover, profit or income, etc. The program allows relational enquiries, when more than one field of the return can be restricted (for example, we may want to know which drinks industries are operating in the state of Rio de Janeiro that have a turnover in excess of BRL 10 million and made a loss in 1999).

With this approach, based on people and systems, the federal Tax Authority of Brazil has been able to face sufficiently successfully all the challenges that have emerged through changes during the last few years.

Weighing risks is part of their classification

In “weighing” the theoretical risk (i.e. determining the urgency and necessity of its detection) two elements should be considered; the *extent (rate)* of the risk, and the *amount* of the risk.

- The *extent* of the risk indicates the probability that a risk indeed materializes. Of each risk identified and classified, the extent (or rate) should be established or assessed. These assessments can be in terms of “high”, “medium” or “low”, or in percentages. If a risk is “high” there is a reasonable probability that the fiscally relevant event will not, or only partially, generate the proceeds that are due according to the law. The term “proceeds” is used intentionally as the risk can be both in respect of the levying and the collection of taxes. A “low” risk signifies a small probability of the proceed actually due to be lower than the proceed due according to the law. For instance, when the turnover of a company is based on cash transactions, the risk that the turnover is not declared completely is in general high. When a turnover of a company is based on bank transactions, the risk is in general low.

- The *amount* of each risk should also be established or assessed. Within this context, “amount” refers primarily to the monetary loss the Tax Administration will suffer if the risk concerned indeed materializes. Initially, the importance is assessed at a macro-economic level. In addition to the financial importance involved in the risks concerned, attention should be paid to such aspects as “image”, “prestige” and creating precedents.

For instance, in general the money involved in selling large assets by a company is much higher than the money involved in the deductible car expenses of a company.

“Weighing” the extent and the amount of a theoretical risk may result in (provisionally) ending the attention to this risk. From the perspective of risk management this implies the risk will no longer be *detected*. The risk is considered relatively insufficiently serious to be worth devoted any attention, and thus is designated as being a non-potential risk. This is the case when the financial interest of a fiscally relevant event that provisionally is considered to be “low” is later linked to a low or medium-sized risk.

If the weighing of extent and amount results in a decision to start detection of the risk concerned (theoretical risk weighing), the risk is referred to as a potential risk. The extent and amount of the potential risk though also influence the establishment of a parameter for signalling. This will be discussed later.

A third alternative is to search for ways to reduce a risk.

3.3.2.2. Risk reduction

A well-known proverb says that “prevention is better than cure”. This saying also applies to the system of risk management. Preventing or reducing a risk is superior (both more effective and efficient) to “repairing” a risk afterwards.

For the fiscal treatment, a further development (future trend) is anticipated towards operating *preventively* or *proactively*. In its essence, this entails preventing risks and bringing forward the moment when attention is focused: from operating up to the present to operating preventively. Preventing losses of tax revenue is both the most efficient (the loss of revenue is minimized) and the most effective approach to the enforcement of the fiscal law.

By creating opportunities for a generic (joint, collective) approach, preventive action generally requires less effort than corrective action. Preventive action may also be in line with the changing role of government in society (see Chapter 1.).

Risk reduction entails decreasing or preventing a risk. It can be seen as a special form of covering risk. By using risk reduction, the probability of the taxpayer escaping his duties and liabilities is decreased. In terms of risk management, risk reduction requires that for each risk it must be established whether, and if so, in which way the risk possibly can be reduced in advance. If risk reduction is properly used, risks may cease to exist, or their extent decreased. As a consequence, the parameters can be set at a higher level so that fewer signals are generated. However, the fiscally relevant event still occurs, but the risk of incomplete tax revenues is decreased by the risk-reducing measures. Thus, fewer actions are required to cover the various risks.

A risk is not always a consequence of intentional behaviour of the taxpayer, but can also be the result of a lack of fiscal knowledge. It may also happen that a risk occurs specifically under certain circumstances, or in certain (groups of) taxpayers, for example in starting companies. These entrepreneurs are frequently unaware of all fiscal consequences of their activities.

A risk can be reduced by, amongst other things, the following generic measures:

- legislation: substituting high-risk elements of legislation for less risky ones;
- education: both in general and for certain (for example, new) legislation, or directed at specific taxpayers (for example, starting companies);
- agreements with, for example, trade or industry organizations, as well as with individual taxpayers (to give clearance to the taxpayer about the interpretation of fiscal law in specific circumstances);
- increasing the perceived chance of being caught.

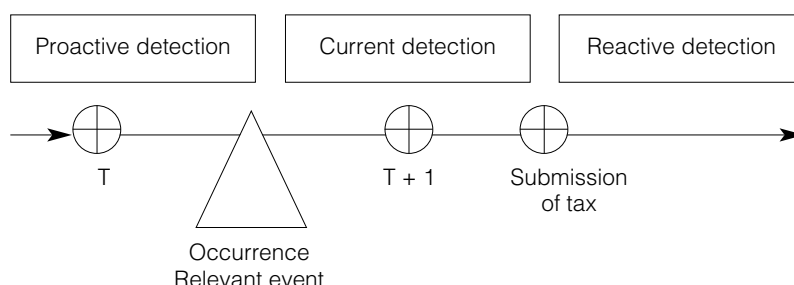
These items will be handled more extensive in section 4.1.

The result of risk reduction is that some risks are eliminated, and thus become a “non-potential” risk. If a risk cannot be prevented entirely, but can be reduced, this will result in setting the parameter limits higher, and thus in less capacity being required for covering the risk.

3.3.2.3. Risk detection

Risk detection means establishing whether a risk *has* occurred, or *will occur* with a certain degree of probability. Next, for each potential risk the possibilities for its detection must be determined.

Risk detection can be done at various instances. Detection is *proactive* if the fiscally relevant event still has to occur. Active/up-to-the-present detection takes place at the moment the fiscally relevant event occurs, or has occurred, and no tax return has yet been submitted (e.g. the moment the company sells a large asset). Detection is called *reactive* if the detection procedures are instituted on the basis of a return submitted (e.g. the signal of a large decrease of assets).



Proactive detection should be preferred, followed by up-to-the-present detection. Only if these two approaches cannot be implemented, reactive detection, on the basis of the tax returns, should be attempted.

When a fiscally relevant event (and thus the risk attached to it) is detected in the earliest stage, it makes proactive or up-to-the-present coverage of the risk possible. Through advance consultation the fiscal consequences of the fiscally relevant event can be established. By the subsequent imposition of a(n) (additional) provisional assessment the financial interest can be safeguarded.

To the extent that the moment of levying tax is farther from the moment of the income being earned, the risk of a loss in collecting taxes increases. In addition to the liquidity effect – the coffers of the treasury being replenished earlier – the replenishment is also larger as a result of the “pay as you earn” principle.

Yet another effect of covering a risk in the proactive or up-to-the-present stage, is on the behaviour of the taxpayer. To the extent that the moment of action is closer to that of the occurrence of the fiscally relevant event, a change of behaviour is easier to bring about. Focused testing, immediate levying, and “tit for tat” are appropriate principles in this context.

Finally, it should be kept in mind that by acting in the proactive or up-to-the-present stages, a maximum amount of information is available. Prime documents are still available. Also, at the moment the taxpayer is most knowledgeable of relevant information about the fiscally relevant event.

From the point of view of the tax officer there are two forms of detection: active detection and passive detection. Detection activities are called “passive” if the tax officer is informed of a risk, mostly automatically by the computer, *without* taking any action himself. With “active detection” is meant that an action or actions of a tax employer is necessary.

The actions of the tax employer can take place outside, e.g. observations at the premises of the taxpayer, but it can also take place at the “tax office” for example, if a risk or a fiscally relevant event in the tax return or in the annual accounts should be detected.

As active detection requires a considerable amount of time and can often be carried out for one taxpayer at a time, it is necessary to use this instrument very consciously.

Active detection will, in particular, be used in the case of:

- fiscally relevant events or risks of a large extent and amount; and/or
- taxpayers with a (relatively) low fiscal integrity.

Where possible, preference should be given to a passive (and computerized) form of detection, for reasons of efficiency, as well as effectiveness (speed and completeness).

Sources to be detected are:

- data from the taxpayer (returns in which fiscally relevant events are brought together and declared, and other reports);
- data from third parties (intelligence);
- data generated by the Tax Administration internally (internal signals).

An example from the last category is the conclusion from a company comparison that the sales of a certain taxpayer in a period of time has

decreased, whereas that of his competitors within the same line of business has increased (trend analysis).

3.3.2.4. Selection

After a risk has been detected, the question arises whether that risk should indeed be signalled to the tax officer. This is called the “weighing of potential risks”: the risk detected is assessed for the urgency to signal it to the tax officer. This weighing is necessary because otherwise all fiscally relevant events that have been detected are signalled to the tax officer. To signal all fiscal relevant events may be superfluous.

Whether a fiscally relevant event should be signalled depends upon three factors:

- Firstly, the financial importance of the fiscally relevant event. Also, fiscally relevant events with a low financial importance usually result in fiscal consequences of a limited weight, making it unnecessary to signal fiscally relevant events with a limited financial importance.
- Secondly, the extent of the risk involved in the object risk. The object risk is defined as the probability that the fiscal consequences of the fiscally relevant events will not be included, or will be included only partially, in the (provisional or final) tax returns of the tax instrument or instruments concerned. In general, the extent of the object risk will be established at a central level.
- Thirdly, the level of fiscal integrity of the taxpayer concerned. He is ultimately accountable for the correctness and completeness of the return(s) submitted. The object risk creates the possibility, constitutes a chance that fiscal consequences will not be included, or will be included only partially, in the return. The extent of this probability is determined by the extent of the (fiscal) integrity of the company and its owners. A high level of integrity may compensate the object risk completely; a low level, though, may not. The integrity of the taxpayer is called the subject risk, and is reflected in his fiscal behaviour. An elaboration of the concept of fiscal integrity (the subject risk) is treated in section 3.3.

A major criterion for the allocation of the available capacity is whether a risk occurs 300 times or three million times in a year. For an adequate assessment (some) insight is required into the fiscal importance of a risk; is the total amount of tax involved one million or 100 million? For the acuteness of the detection measures it is also important to know whether

difficulties occur in 100% of the incidences, or just in 10%. In the latter case, detection must be more stringent in order to ensure that precisely those 10% are identified for more detailed scrutiny. The same considerations apply in weighing clients; information on both the number of clients involved and the importance must be obtained and inferred.

By determining the weight of these three factors (fiscal importance, extent of object risk, and level of fiscal integrity) it will be possible to establish a threshold level (parameter or tolerance limit) for its category of attention intensity. With this parameter the weight of the potential risk can be determined.

Only *above* this threshold will a (passively or actively) detected fiscally relevant event be considered a relevant risk and thus result in a signal to the inspector/tax auditor.

All things being equal, for taxpayers with a low fiscal importance and a low level of object risk the threshold level/parameter will be higher than for taxpayers involving a high risk/importance.

An example of the practice in Brazil:

Tax Action Management System (Siga)

The Brazilian Tax Authority has a powerful and flexible instrument for selecting taxpayers for inspection, based on data warehouse technology, which allows risk analysis in respect of a universe of 15 million private individuals and four million bodies corporate who submit returns each year.

Apart from the information provided by the returns, the information collected from third parties, information provided to the tax authorities at state and municipal level, information on financial movements, transactions involving private property and real estate subject to public registration, ownership of vehicles, aircraft and boats, are a very important source of data for cross-referencing, in addition to any other relevant information concerning a taxpayer or a group of taxpayers who might be of fiscal interest.

Apart from allowing the storage and retrieval of an immense mass of information, Siga also allows sectorial investigations to be made from national level to municipal level, which allows inspection programmes to be imple-

mented that are aimed at a certain locality or region in view of its economic and fiscal relevance.

3.3.2.5. Covering risks

When a risk is signalled, the risk has to be tackled. Now, there is a relevant risk.

The way in which such a risk is covered may depend upon the industry, the category of intensity of attention, or the fiscally relevant event itself. In each case, efforts should be made to cover the risk by means of the most effective and efficient form of treatment. In covering a risk, the tax officer will preferably be supported by a treatment programme that is geared to the risk. A treatment programme tells the tax officer what to do to tackle the relevant risk.

In its essence, the covering of a risk entails assessing whether the fiscal consequences of a fiscally relevant event have been included completely and correctly in the books and accounts, and in the tax return. Should this not have been done, it is a case of non-compliance, requiring the financial effect of the non-compliance being eradicated. This can be achieved by correcting the final assessment (where reactive risk detection covering methods are used), or by imposing an additional provisional tax assessment (in the case of a proactive or up-to-the-present handling of risk detection and risk coverage).

A collection risk can be covered by demanding (or having demanded) security, identifying possibilities for recovery, payments agreements or making a person liable.

3.3.2.6. Evaluation

Evaluation and feedback are essential elements of the risk management process. Evaluation is necessary in order to learn from the process and to increase its accuracy. Evaluation makes it possible to refine the process model, and to achieve greater efficiency. The feedback of any results and conclusions from the evaluation process provides an important input for the Tax Administration's decision making. It is therefore necessary to evaluate not only each individual step but also the process as a whole.

The feedback will have a two-fold impact:

- Firstly, it will provide information with regard to decisions on auditing strategy, and auditing policy and auditing plans, and to the overall planning of operational auditing activities. It will also be an essential tool for the allocation of human and technical resources.
- Secondly, the results will have a direct impact on the model itself. As the evaluation needs to cover all four steps, as well as the process as a whole, the outcome could directly be translated into decisions which reinforce the various steps, as well as the process as such. If tax auditing is principally based upon risk analysis, it will be of the utmost importance to regularly evaluate the model and its outcome.

When the outcome of a risk is less than expected (on basis of the research activities), one has to search for the reasons. Is the risk dealt with in a wrong way, is it still a risk or is there another reason for the disappointing outcome?

Next to the information of the examination of signalled risks, information of random examinations (examinations without a special reason) can give additional feedback. The random examinations can give information of non-identified risks.

For this purpose some countries have a random test, i.e. 1% of all examinations are random examinations.

An example of a practice in the United States:

In the United States, the Internal Revenue Service periodically conducts the National Research Program which is designed to measure voluntary compliance levels and helps effectively to identify specific compliance issues. Under the programme, a small, statistically valid, sample of returns is examined to gather data enabling the IRS to update existing computerized screening models used to select returns for examination. The information facilitates the selection of returns with the greatest compliance risk.

3.3.3. Fiscal integrity; subject risk

The starting point of the treatment strategy is that a taxpayer must receive the attention he deserves; the higher the risk that a taxpayer behaves in a non-compliant fashion, the more attention from the Tax Administration he requires. The risk that is assigned to an individual taxpayer consists of two

components: the fiscal importance and the fiscal subject risk. To make the fiscal importance and the subject risk operational concepts, a model must be developed with which fiscal importance and fiscal behaviour can be measured and recorded. By means of this model each individual taxpayer can be coded. In this way homogeneous groups are created consisting of taxpayers who, on the basis of their fiscal behaviour and fiscal risk, deserve equal attention.

An exception is made for the very large companies. They are not classified as homogeneous groups and the classifications mentioned above are not used for the selection of those companies. Because of the very large fiscal importance and the special problems (e.g. international aspects), they have to be treated individually. For those companies treatment must be made to measure. This has to be done by the specialists.

A classification according to the fiscal importance of taxpayers may be established, for example, by measuring the (total) tax liability in a calendar year. A possible classification of fiscal importance is:

Code	Fiscal importance	Turnover per annum (EUR)
3	low	e.g. less than 100,000
2	medium	e.g. between 100,000 and 500,000
1	high	e.g. more than 500,000

Other classifications are possible. Another distinction could be the payment performance.

How categories are designed and how limits are determined depends upon the circumstances of individual countries. On the one hand, the classification must be distinctive, on the other hand, too many categories will result in a large number of mutations. The starting point for such a classification may be categories comprising, respectively, 25%, 50% and 25% of taxpayers.

A classification of the fiscal subject risk can be established by measuring the exhibited fiscal behaviour of a taxpayer in the recent past. Although, for reasons of equality before the law, it is very important that the criteria on which the determination of the subject risk is based, can be applied objectively. Examples of such criteria are:

- behaviour with regard to tax returns for all tax instruments during the past 12 months (timeliness, compliance with obligations);
- payment performance (regularity and any arrears);

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- any adjustments following checks in the past (amounts and nature);
- preparedness for having preliminary consultations;
- fiscal complexity;
- quality of books and accounts;
- behaviour of the line of business;
- behaviour of the management;
- behaviour of the accountant.

A special category consists of those taxpayers who do not have a fiscal past, the new starting companies. It is recommended to classify these taxpayers in a separate group until they have built a fiscal history.

Just as for the classification on the basis of fiscal importance, the number of categories of fiscal risk should not be excessively large. For example:

Code	Fiscal risk	Score for the criteria
S	Unknown (starting companies)	No history
A	Low risk (reliable)	Compliant behaviour
B	Average risk (unpredictable)	Elements of both
C	High risk (unreliable)	Non-compliant behaviour
D	Very high risk (fiscally criminal)	Fiscal criminal prosecution

Combining the classifications of fiscal importance and fiscal subject risk produces the following matrix:

		Low	Average	High	Very high
High	S	1A	1B	1C	D
Average		2A	2B	2C	
Low		3A	3B	3C	

With this matrix all taxpayers can be classified in a limited number of groups. The classification may then be used in the selection process. See also section 3.3.2.4.

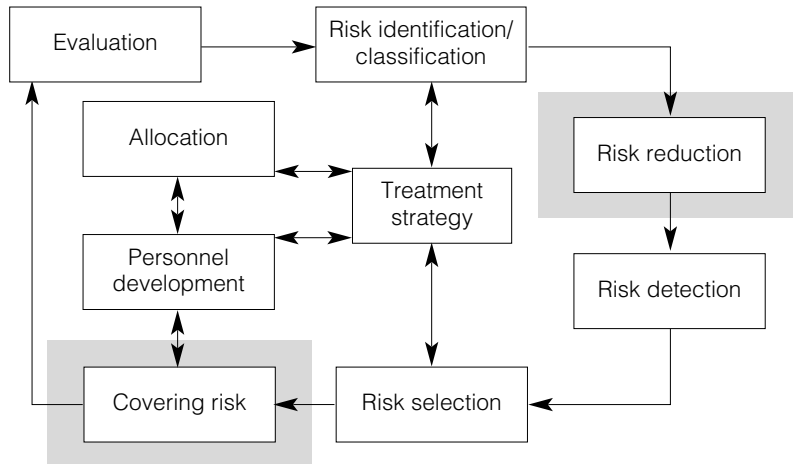
3.4. Treatment strategy translated in forms of treatment

There is an interrelationship between the risk management process and the treatment strategy. The treatment strategy reflects the degree of attention, the form and the intensity of the treatment. The degree in which the treatment strategy, as it has been established, will indeed be implemented in practice, is determined by such aspects as the available capacity and the

Treatment strategy translated in forms of treatment

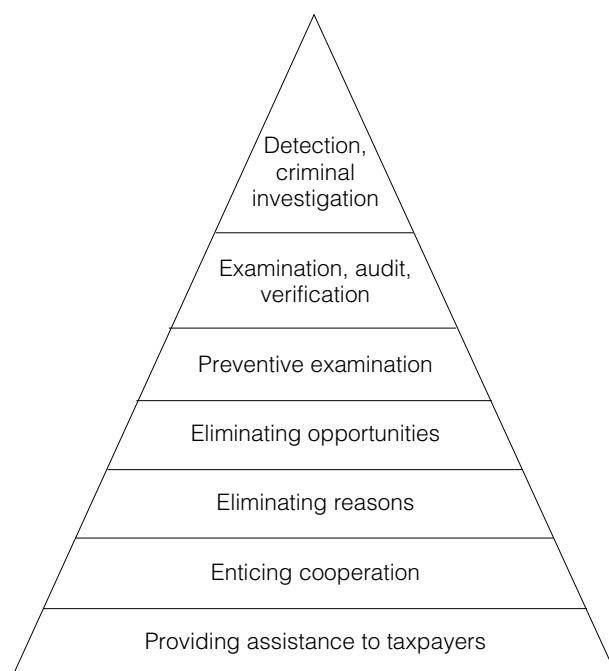
level of training and development of the employees. The diagram in the figure below illustrates this interrelationship.

Model of law enforcement: relationship between treatment strategy, allocation, risks and treatment form



On the basis of the treatment strategy selected, various forms of treatment can be applied. This section provides a description of the principal features of these treatment forms.

The elaboration of the treatment strategy is based upon the enforcement pyramid which includes all treatment forms.



A treatment form stipulates in which way a risk should be covered. Obviously, the generic treatment forms also serve to enhance compliance.

Within the enforcement pyramid two main flows of specific activities, together with their associated treatment forms, can be distinguished:

Main flow of activities	Treatment form	Examples
Proactive/up-to-the-present activities	1. Actively providing information	Visits to starting companies Company visits; preliminary consultation, observation on site
	2. Proactive/up-to-the-present checks	
Testing/reactive activities	3. Validation	Partial audits, full audits, intensive investigations, investigations into fraud, campaigns
	4. Verification	
	5. Audit	

On the one hand, proactive/up-to-the-present activities consist of actively providing information (specifically addressed to one taxpayer) and, on the

other hand, of a wide range of treatment forms that are taken from the following levels of the treatment pyramid:

- eliminating opportunities;
- preventive examination.

3.4.1. Proactive activities

A risk can be reduced by, amongst other things, the following generic provisions:

- legislation: substituting high-risk elements of legislation for less risky ones;
- education: both in general and for certain (e.g. new) legislation, or directed at specific taxpayers (e.g. starting companies);
- agreements with, for example, trade or industry organizations, as well as with individual taxpayers (to give clearance in advance to the taxpayer about the interpretation of fiscal law in specific circumstances);
- increasing the perceived chance of being caught.

Legislative activities are concentrated in the Ministry of Finance. This method of risk reduction often needs the approval of parliament.

In the area of risk reduction, the individual Tax Administration employee, inspector or tax auditor has a special duty with regard to providing information and having preliminary consultations, or giving clearance in advance. Often these activities will be “cash in” through (additional) provisional tax assessment (this will be discussed in more detail further on in this chapter).

The perceived chance of being caught is the assessment made by taxpayers of the risk they run that their non-compliant behaviour will be found out and tackled by the Tax Administration. The perceived chance can be increased by an appropriate treatment with noticeable examination and focusing attention to this examination through targeted publicity.

Many countries instituted a communication and information programme for taxpayers in the period preceding the period for submitting the income tax returns of private individuals and bodies corporate concerning the most complex points of the legislation and the most frequent doubts. This programme uses mass means of communication, including the Internet, and offers call centres or personnel for clarifying any doubts and for informa-

tion regarding the provision of good quality information in the returns submitted.

An example of risk reduction in the Netherlands is the consultation between the Tax Administration and the industry organizations that has been going on for years now.

Through these meetings, parties make agreements on numerous standards in the agricultural sector. As a consequence, the risk that for these items there are errors in the tax return, is reduced considerably.

Spain is stimulating the agreements with taxpayers on the aspects of valuation of specific transactions. The agreements have to be settled, before the transactions can be executed. It concerns the following aspects:

- transactions between united companies;
- adoption of undercapitalization;
- an estimation in advance of costs of scientific investigation or technologic innovation;
- valuation of expenses in other means than money;
- an estimation of costs of management and control of a fixed company in Spain.

The agreement, or the disapproval, must be made within six months after the taxpayer's request.

In Argentina portable technologies (notebooks and palmtops) are being used to perform large-scale monitoring and preventive tax inspections, with very good results. Technical tools such as notebooks and wireless connections are being used in monitoring, specifically in the following areas:

- On-road and invoicing control. In these cases, a notebook connected to the Internet through a data transmission interface (such as a cellular connection that uses a trunking or PCS system, or a satellite system) is used to instantaneously query updated information. The queries are done online and the answers are stored automatically, thereby eliminating the need to enter the data afterwards at the offices and allowing to detect repeated use of supporting documents. This type of monitoring can immediately determine if supporting documents are valid (authorized by the AFIP), if they are currently in effect (not expired), if the reference data on the vouchers belong in fact to registered subjects, if the tax printer installed is registered, if it is an AFIP-approved device, etc.

- Checking of social security registration. The equipment mentioned in the previous point can be used to check that an employee has been registered at the Social Security; this procedure is used at the time of the staff survey. The query capabilities include instant access to the complete payroll of individuals registered at the company being inspected, the date on which registration was granted, information on whether the employees have been registered by more than one employer, etc., as well as official registration by the inspector.

3.4.1.1. Actively providing information

One of the forms of proactive/up-to-the-present activity is actively providing information. This can be addressed to individuals and/or to large groups of taxpayers.

If addressed to individuals, the taxpayer receives tailor-made information. An example of individual education and information is paying a visit to a starting company. The objective of such a visit is to provide information on fiscal laws and regulations. The starting business person will also be pointed out his accounting obligations in accordance with the requirements of his company. The visit to a starter will accordingly be directed at eliminating any grounds for unacceptable fiscal behaviour by filling in any lack of knowledge and information.

An example of a practice in Brazil:

Special register at the Tax Authority for certain activities

Some economic activities that are characterized by a high risk of failing to meet tax obligations require more rigid measures on the part of the Tax Authority to cover the degree of this risk.

The sectors that operate these activities, such as, among others, the manufacture of alcoholic drinks, cigarettes, audio visual and sound productions are subjected to a type of control which imposes on them obligations that have to be met before they start their activities. This control is known as the Special Registration.

This control instrument includes providing, in advance, information regarding the product that will be produced, in which quantities and for which destination, and proof of the effective production capacity, apart from the fiscal suitability of the partners and directors. In addition, the

activity subject to the Special Registration can only be performed within the scope of this instrument, which means that if the conditions for granting it subsequently cease, it will be revoked and the activity cannot be performed any longer.

The control seals, made by the mint, and which must be applied for some products of greater risk of tax evasion, are only supplied by the Tax Authority for the holders of the Special Registration in effect, particularly in the case of cigarettes and alcoholic drinks.

Massive education is achieved through information campaigns which may, for instance, be organized by the Tax Administration itself. In such a campaign taxpayers are informed of, for example, the new legislation that will be enacted. Various media can be used for these campaigns, varying from extensive television spots, sites on Internet to personalized letters.

An example of a practice in the Netherlands:

In the Netherlands it was decided that owners of gambling machines should keep a written record of the counts. The machine counts increase the auditability of the proceeds.

All owners of gambling machines known to the Dutch Tax Administration were sent a letter in which this obligation was pointed out. As a follow-up, they were all paid an informative visit by employees of the Tax Administration.

3.4.1.2. Proactive/up-to-the-present testing

One of the goals emanating from the strategic objective of compliance is “optimizing the tax revenue” in terms of both the moment in time of the receipts and the completeness of liabilities and payments. An important instrument to achieve this goal is “operating up to the present”. However, to be able to do this, it is necessary that detection activities are also carried out proactively and up to the present. Of course, there must be a legal basis to do these types of test.

An example of a practice in Argentina:

Preventive tax inspections: these inspections are not primarily focused on a certain type of taxpayer, but rather aim to enhance the visibility of

Argentina's Tax Administration to the taxpayers and to bring about changes in their behaviour. These types of inspection are carried out to verify their compliance with registration and invoicing systems with regard to existing operations, and have a limited duration. Nevertheless, they have significant repercussions on the public opinion due to the large number of inspections performed. This type of tax inspection is based on a series of activities at the location where the taxpayer conducts its business, or in public premises with a high concentration of commercial or transport operations.

As a result, these inspections are massive in nature and can address specific taxpayers (in pre-determined sites) or taxpayers in specific geographic districts, with the purpose to create or increase the risk of taxpayers being found out through the presence and actions of officers of the Tax Administration.

The duration of the inspections is rather short, and generally ends immediately after a specific task is accomplished. Nevertheless, the compilation and analysis of the information thus gathered and comparison with the data provided by the taxpayers in their tax returns frequently reveal inconsistencies that lead to some other type of tax auditing by the tax agency. This may be a verification or, in most cases, an audit.

Seen from the perspective of the Tax Administration, operating up to the present should result in both a faster cash flow ("pay as you earn") and a reduced probability of collection losses. Operating up to the present also means that "facts" are still observable, and that prime documents are still available. As a consequence, the amount of the (material) tax liability is more properly and readily established. By behaviour influencing methods ("tit for tat" policy) the conduct of the company can be changed, resulting in a larger amount of tax revenue coming in "autonomously". This has a positive effect on the completeness of the incoming cash flow; the receipt of taxes.

Operating up to the present has also benefits for the taxpayer. A company will certainly appreciate speed and knowledgeability, and by its nature a company is more focused on the present and the future than on the past.

An example of a practice in the Netherlands:

The function of the provisional assessment (for assessment taxes)

Covering the relevant risk may result in reaching an agreement to have the fiscal consequences of a fiscally relevant fact (yet) reflected in the (final) tax return (future oriented). Within the context of directly levying taxes, this means that also the provisional assessment imposed earlier needs to be adjusted through an additional provisional assessment. The fiscal consequences of the arrangement are, as it were, translated into an additional provisional assessment. The (additional) provisional assessment reflects continuously the level of the real tax liability as it would be on the basis of the available information (the expected situation). Any differences are the result of the Tax Administration not being informed or not being knowledgeable, of the market taking another turn, or of an other fiscal choice having been made.

Another consequence of this procedure is that, if the arrangements made in the course of the year have been implemented in fiscal terms, the final assessment is not, or is hardly any different from the additional provisional assessment. For this reason, checking the final assessment has become unnecessary. On the other hand, this means that any relevant deviation of the (additional) provisional assessment from the final assessment may reflect different developments in the market of a different fiscal choice. A substantial difference between the (additional) provisional assessment and the final assessment thus becomes an important (general) source for detection (or a selection criterion) which, after further investigation, may result in the detection of several risks.

It may also occur that a taxpayer or his consultant makes an interim request for a reduced additional assessment. This is also an important (general) signal within the context of up-to-the-present treatment, as it indicates that something special with fiscal consequences is taking place, or has taken place, in the entity concerned. Especially in the “high attention” category such a signal will almost always result in a visit to the taxpayer, and in a special evaluation of the request for a reduced assessment. The expected fiscal situation will have to be adjusted for the signal received. Thus, the arrangement for provisional assessments changes into a form of establishing assessments. Bad estimators, though, receive additional penalty points that are used in determining to which risk category they belong, and thus in determining the category for the intensity of the attention taxpayers receive.

Finally, the reverse of the request for a reduced assessment is the “officially estimated reduced assessment”. If, as a consequence of a calamity and a decline in economic activity (for example, a flood, swine fever, or BSE in cattle), a cut in the level of operational results is almost a certainty, the up-to-the-present treatment entails that the tax officer actively consults the taxpayer or his consultant in order to agree upon a reduction of the amount of the provisional assessment. This particularly applies to taxpayers in the low risk categories. In this way, the Tax Administration rewards the good fiscal behaviour the taxpayer has exhibited.

Operating up to the present also means that if the risk has been covered up to the present and has been “cashed in” through an additional provisional assessment, the Tax Administration is bound to its position. This is a logical consequence in view of the intended sped-up security before the law, and the intended redirected emphasis towards provisional assessments. It requires, though, that the quality of the current activities and procedures should be of a sufficiently high level.

Proactive or up-to-the-present treatment may or will result in a revision of the provisional assessment. Through this revision, the value added (the revenue) by operating up to the present becomes clear.

3.4.2. Reactive/testing activities

Testing activities refer to checking the tax returns submitted, and result in a judgement regarding those tax returns.

3.4.2.1. Validation

Within the context of risk-oriented operating, the (final) selection of tax returns serves as a safety net in the detection of identified risks and risks that have not been found earlier.

In this process a computer is effective and efficient, but elements of the process can also be done without the computer.

The safety-net function is based upon the argument that quite a number of risks can be detected well before the arrival of the income tax return or corporate income tax return at the tax office (operating up to the present). Thus, the selection of tax returns has only a limited usefulness (safety net).

A large number of risks, however, can still only be detected on the basis of the final return, particularly in cases where technically fiscal choices have been made after the books were closed. The selection of tax returns concentrates on these risks in particular.

In order to be able to select the risks at the arrival of the tax return, it is necessary to establish nationwide criteria and to incorporate them in (computerized) systems for processing tax returns. These selection criteria should be applicable to all persons liable to pay taxes. Establishing them centrally, considerably enhances the settlement of tax returns in accordance to the principle of equality before the law.

The system of tax return selection is in agreement with the principles of allocation attention: more attention should be paid as the fiscal importance and/or the fiscal risk increases.

In principle, tax returns in the low risk categories can be processed, although output (the selection for a particular risk) can be obtained only if there is an “eject ground”. An “eject ground” is a signal of a possible incorrectness in the tax return that deserves closer attention of the processing staff.

Tax returns of taxpayers in the category average risk and average importance will be ejected to be checked further whether they manifest one or more risks or a relatively small set of risks (active risk detection). When these tax returns indeed include any of these risks, they are passed on to be dealt with by an inspector or auditor.

Tax returns of taxpayers that belong to a particular attention category, e.g. S (starting companies), or D (very high risk) should always be ejected in order to be handled by an inspector/auditor.

Detection and selection are based on selection rules and criteria. These rules and criteria have been developed and proposed by experienced tax officers. The management of the Tax Administration ultimately decides which selection criteria will be incorporated in the system for processing tax returns.

Obviously, in setting the selection rules and criteria the available capacity will be taken into account. Part of the available capacity will be set aside for preliminary consultations, detection and active selection.

In addition to passive detection and selection, active detection and selection procedures are performed in which human resources capacity should be made available at the level of the units as active detection and selection cannot be computerized (for instance, observation on site, detection).

Many countries, e.g. Brazil, the Netherlands and Spain, computerize the receipt and reading of the tax returns. The aim was to minimize the manual work to get the data of the tax returns in the systems. These data make a systematic checking of the returns submitted possible.

As an example the practice in Spain:

- Development of supporting systems to fill in a tax return. Taxpayers only have to fill in some data. The supporting system is making up the tax return. This tax return can be sent to the Tax Administration by Internet or it can be printed and sent by mail. When a tax return is printed, the first page has a specific code. This code represents the data of the tax return and can be read by the computer. In this way manual input of the Tax Administration is minimized. These supporting systems are available for the most important taxes. For example, of the income tax returns 90% is processed in this manner.
- Tax returns by Internet. In Spain there is a general use of Internet in the contacts with the Tax Administration. Large companies have the obligation to file their tax returns monthly by Internet. Other companies do not have such an obligation. For private persons, 10% of the tax returns are filed by Internet.

A metaphor

From the above the conclusion could be drawn that people could eventually be replaced by robots, that persons can no longer contribute personally as a result of the unity of policy and execution. Perhaps the following metaphor can shed some light on the matter.

By their concealing, evading and avoiding actions taxpayers can frustrate the system for the levying of taxes as it is intended by the government. Money that escapes the coffers of the state constitutes an infringement of the rules, and is thus a risk that must be fought. Risks thus identified and classified are of varying severity in terms of both fiscal importance and the intensity in which they should be tackled.

Business and industry, and in particular the computer sector are confronted by an identical problem. Their fight is against the risk caused by viruses.

These viruses may damage computer programs and files, causing the computer system to run less smoothly than it should. With regard to home computers, the importance of these risks will usually be low. The owner would be advised to incorporate into his system a standard virus recognition program. This detector is continuously or periodically updated and the owner is reasonably protected from fatal external influences. As long as viruses demonstrate known patterns, the detector will do its job with the speed of light, and will signal any attempt to encroach the system. Experts are constantly engaged in detecting and investigating new viruses. If they discover any, they supplement the detection program and update it.

It would not be sufficient to both the computer sector in the world of business and Tax Administrations to just have the use of a computerized method for covering risks. More is required. As the interests become greater, the computer sector must deploy heavy weapons in addition to the generally available virus detection programs in order to prevent any damage to computer software and data files.

In large companies and government bodies, therefore, the best trained and equipped employees will be working at protecting vital data from being damaged.

In a Tax Administration the most competent officers of the units will thus be engaged in finding out whether the law contains any gaps, and whether these gaps are used to frustrate the levying of taxes. In the metaphor this is comparable to damaging computer programs.

In addition, other specialists of a Tax Administration use their knowledge to detect vital risks in respect of taxpayers who probably present such risks. This is the individual approach used for the largest taxpayers. The more a Tax Administration is able to capture risks in fixed patterns, the more time becomes available for inspectors/auditors and specialists to deal with taxpayers and cover their risks on an individual basis.

From the above it will be clear that the Tax Administration will attempt to free as much quality time as possible by using computers in order to shape the risk-covering process.

Some officers may experience having to operate with uniform tools and standard guidelines (such as an audit programme) as a kind of straight-jacket. The real specialist, though, will soon discover that she or he is not hampered by them in applying their professional expertise. In the structure

presented here, the profession is only offered the tools with which he or she can work more efficiently and faster.

The activities that are performed during the risk-covering stage, i.e. tackling risks, knows various forms of treatments, such as the verification and the audit.

3.4.2.2. The verification

The verification is a form of examination, at the premises of the Tax Administration. The instruments available to the inspector are obviously less far-reaching than those for carrying out an audit at the address of the taxpayer. In judging the tax return, the inspector may use data that are available at the tax office and the replies a taxpayer may have given to questions the verifactor (desk auditor) has put to him by telephone, in writing or in a personal contact with the taxpayer at the office of the Tax Administration.

Examples of data which may be available to the verifactor (desk auditor) are:

- data of interest received by the taxpayer and balances of bank accounts (according to statements by banks);
- data on payments by insurance companies and insurance contributions paid;
- data on salaries and wages (according to reports by the employer);
- data on shares in companies and dividends received (according to reports by banks);
- data on other levies and taxes;
- data concerning the value of property;
- data on mortgages (according to statements by banks);
- deeds and acts by notaries public;
- data the Tax Administration has gathered on an ad hoc basis (for instance, in audits of companies);
- industry data;
- literature on technical tax issues.

Of course it is more effective and efficient if the data are available in digital form and a lot of these data are a part of the database of the taxpayers.

In applying the risk management model the desk auditor deals with the ejection ground of any taxpayer ejected from the computerized system, i.e.

the selected risk. The tax return should not be checked completely for any other adjustments to be made. Obviously, this does not mean that any clearly evident grounds for adjustment should be neglected, even if the tax return was not ejected for that ground. Common sense will have to decide how thorough the other risks in the tax return should be dealt with.

An example of a practice in Argentina:

In 2001 in Argentina, a computer tool was designed to cross-reference the data recorded in the database of Argentina's tax agency against external information from the property registries, motor vehicle registry, national aircraft registry, withholding agents, key buyers in the domestic market, etc.

This database is currently in operation in all inspection districts. The information is sorted geographically by the taxpayer's residence, and is adapted to the needs of this methodology through the implementation of various computer capabilities linked to the steps of this process, namely:

- pre-selection;
- case analysis and selection;
- automatic issuing of summons;
- monitoring of the entire procedure.

The desk auditor has to make notes of the verification systematically, on paper or digital. In this way findings and conclusions are easily retrieved and clearly defined in an internal audit or during the objections and/or appeal stages.

Taxpayers have to be informed about the adjustments made. In a number of countries it is customary to contact the taxpayer before any intended adjustments are made. This contact may be in the form of a meeting at the tax office, by telephone, or by sending a pre-announcement. After the meeting at the tax unit or the telephone call, a pre-announcement is sent, unless an agreement was reached during discussions.

In many countries the taxpayer is informed of any adjustments not only through a pre-announcement but also through a clearly drafted announcement of adjustments.

An example of a practice in the Netherlands:

In the Netherlands, contact before any (intended) adjustments in the tax returns are made is not necessary, if such adjustments exclusively consist of:

- negative adjustments of the income declared; or
- apparent counting and copying errors.

3.4.2.2.1. *Adjustment policy and tax revenue*

It is not effective to implement any possible adjustment, because small adjustments cause needless resentment and the operational costs of implementing small adjustments are higher than the tax revenue from these adjustments.

3.4.2.2.2. *Official estimated assessments*

Not all taxpayers submit their tax returns in time. In these cases the assessment will have to be settled through an official estimated assessment. This involves estimating the tax liability by means of the verification.

For assessments that are settled through official estimates the starting point should be that the material tax liability must be as correctly established as possible.

3.4.2.3. *Audit*

This paragraph presents the model of the tax auditing process. The starting point of this auditing process is the audit assignment. If, following the selection process, it is decided that a certain taxpayer deserves extra attention in the form of an audit, an audit assignment is prepared. In judging whether or not an audit should be instituted, a major consideration is, of course, whether sufficient capacity is available.

In general, an audit assignment entails that an examination of books, records and other documents should be carried out. The first objective of an examination of books, records and other documents is to determine the acceptability of (parts of) the tax returns. To do so the tax auditor checks whether the tax returns are correct and complete. The second objective of the examination of books, records and other documents is to establish

Chapter 3 - Risk management and the related treatment forms

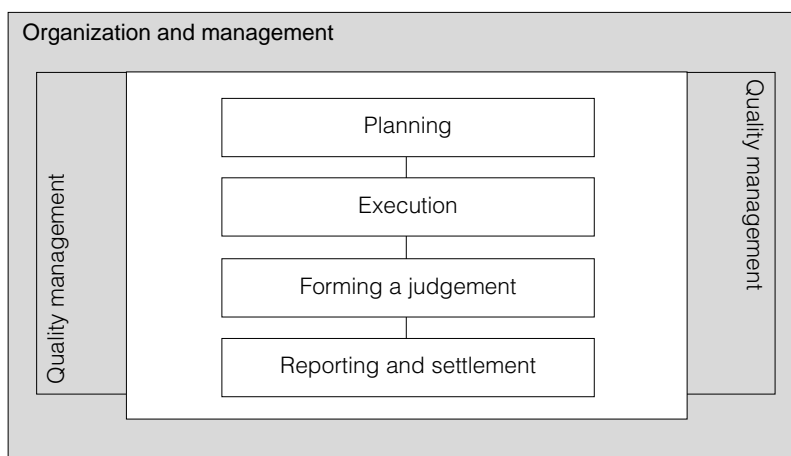
whether the taxpayer has complied with the other regulations and obligations the legislator has imposed on him. These provisions and obligations may have been laid down in tax laws (see Chapter 1). From these two objectives, specific auditing objectives are derived that pertain to the auditing policy as it is carried out, and that are geared to an individual taxpayer, or group of taxpayers.

With respect to the audit of books and records, the audit assignment stipulates which (parts of the) entity, and which (parts of the) tax returns should be audited. This is important to the tax auditor because the audit assignment indicates what is expected of him.

The auditing process

In order to fulfil his assignment properly, the tax auditor must take decisions on the nature and extent of his audit that are sound from a technical point of view. Accordingly, he must have insight into the business processes of the entity, as well as into the target group which this entity is part of.

As a framework for these decisions, several steps are distinguished within the auditing process of the Tax Administration. These steps are included in the following model.



This model serves as a guideline for the description of the auditing process. The following paragraph concentrates on the organization struc-

ture on which the model is based. In Chapter 4 this model is elaborated on in more detail with regard to the aspects of execution.

3.4.2.3.1. *Organization and management*

The organizational arrangement and the management of the auditing process must ensure the Tax Administration that the execution of the auditing process meets the quality requirements.

Quality management

Within each of the units of a Tax Administration a set of measures must be operational that are aimed at assuring the quality of the auditing process.

3.4.2.3.2. *Keeping files*

At each stage of the auditing process the officers involved must keep a record of the procedures they have carried out and the related conclusions. This record is to be included in the audit file. Keeping files makes it possible to be accountable for an effective and efficient approach and execution of the tax audit.

From the audit assignment through the reporting stage the audit file must provide insight into the data used, the grounds and arguments, and the decisions taken with regard to the approach followed, the planning of the process, and the execution of the procedures of an audit.

The audit file must contain, as a minimum, the audit assignment, the audit programme (the approach), the findings and conclusions, a copy of the audit report, a time record, and a record stating that the procedures have been evaluated, and who has evaluated them. In general, the object at which the audit is directed is a tax return and the books, records and other documents on which this tax return has been based. An audit, though, can also be directed at possibilities to collect a tax liability, i.e. an investigation into the possibilities for having recourse (collection investigation).

In view of the increasing volume of information available to the Tax Authority, and the multiple possibilities for its use in audit procedures, in many countries a computerized system has been developed which captures in the various databases formed by data received from the taxpayers via

returns and data collected from third parties, all the information concerning a specific taxpayer.

3.4.2.4. Objection and appeal stage

If a taxpayer does not agree to the assessment as it has been imposed, he should have the right to object against it. This should be one of the rights of the taxpayer.

His notice of objection must, of course, be taken into consideration by the Tax Administration, and the Tax Administration will have to make a decision on the objection. The taxpayer should have a reasonable time to object, the objection should be dealt with by an independent person and the whole procedure should be transparent.

To avoid unnecessary objections there is a special procedure in Argentina:

Discharge of cases by the inspector and follow-up of statements that were not accepted by the taxpayers must be routed for an official estimated assessment. Before the actions are discharged, the head of the official assessment department should approve the inspector's discharge so that any additional documents or evidence required can be provided during the tax auditing stage. This procedure prevents non-substantiation of assessment processes after a tax audit.

In the United States, like many other countries, taxpayers can object to audit assessments using an administrative objection process. A special office provides a forum for taxpayer objections independent from the IRS examination function. Over 90% of cases not agreed at the examination level are resolved without litigation using this process.

After the objection stage, the taxpayer should have the right to lodge an appeal against the tax assessment imposed on him.

An institution independent from the Tax Administration should handle these appeals against the tax assessment. In this way the "Trias Politica" (segregation of powers of law, powers of execution and powers of Justice) is secured.

Treatment strategy translated in forms of treatment

An example of a practice in the Netherlands:

The taxpayer is allowed to appeal to the courts of justice. In these courts of justice special judges have been appointed who exclusively deal with tax cases.

CHAPTER 4

TOOLS TO SUPPORT EXAMINATION AND AUDIT

4.0. Introduction

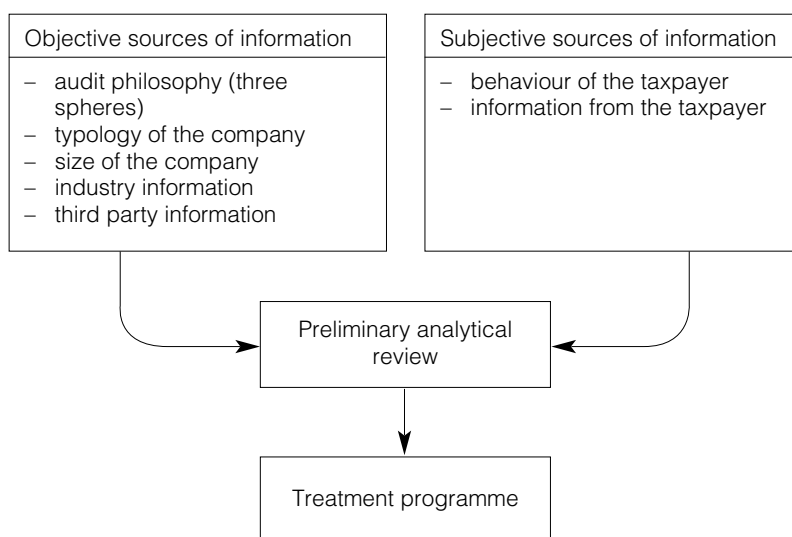
Chapter 3 has described the risk analyses as a selection tool. Chapter 4 presents the required information, the audit approach and the available tools for auditing a specific taxpayer or a group of taxpayers.

The premise of this chapter is that a Tax Administration must have at its disposal all information required for treating taxpayers in general, and for tax auditing in particular. For the purpose of fair taxation, a Tax Administration needs to know all fiscally relevant facts of the taxpayers, including taxpayers who operate on an international scale. Having available all fiscally relevant data of taxpayers has two sides: the obligations of the taxpayer and the competences of the Tax Administration. The obligations of taxpayers with regard to information can be divided into:

- obligations with regard to information for the levying of taxes on the taxpayer himself; and
- obligations with regard to the levying of taxes on third parties.

The foundation of the information available to a Tax Administration is the books, records, and other documents of the taxpayer. Regulations on the accounting obligation, as well as on the obligation to retain books, records and other documents are essential in this respect. As to the obligations with regard to information relevant to the levying of taxes on third parties, the information obligations of public accountants, tax consultants, banks and governmental bodies are of particular importance. The competences can be translated in guidelines that apply to a tax audit, see Chapter 1. Under these regulations and guidelines it may occur that the rights of taxpayers set limits to the competences of the tax auditor.

There is objective information, which is not influenced by taxpayers' behaviour, and subjective information, which is from and about the specific taxpayer. In order to draw up a treatment programme, which is effective and efficient, the auditor must gather both objective and subjective information. This will lead to a specific risk analysis in the preliminary analytical review.



4.1. Sources of information

4.1.1. Objective sources of information

4.1.1.1. Introduction

What is tax auditing?

Tax auditing can be described as testing observations against objective standards. Within this context business activities can be considered standards, while tax returns are the observations. Books and records, and other accounting data constitute the link between standard and observation. The basis for this preposition can be found in the theory of the three spheres.

Theory of the three spheres

The first sphere is reality itself. Reality is what a Tax Administration wants to learn about. This can be achieved by observing activities and processes. Of course this observation can be done during an audit, but the information would not be very reliable as there will be a tendency to conceal things during the days of the audit. Also, business activities can be on other locations (construction work) or at other times (a night bar). Nevertheless, it is always useful to watch what is going on. A more effective form of observ-

ing reality is “observation on site”: a surprise visit to a company, with a well-considered programme.

The essence is: if you have not been there, you will never fully know reality as it is. As the Tax Administration cannot observe business activities all the time, the internal procedures and control measures of a company are important. They can provide some certainty, especially in larger companies. The internal control measures of the company are partly irreplaceable: no matter how much work and effort the tax auditor spends on auditing the company, he will never be able to replace these internal controls.

The second sphere is the reflection of reality, i.e. the books, records and other documents. Reflecting reality starts with prime documents and records, followed by computations, the entries in accounts, the general ledger, the trial balance, the adjustments after the year-end and the annual accounts. Correspondence, quotations, records of incoming orders, routing schedules of company vehicles, cost estimates, cost analyses, internal reports, etc. must not be ignored. The starting meeting of the audit must clarify what the company is about, and what is useful or important to it. It is essential to know the line of business.

The third sphere is the “mirror image” of the second sphere: the tax return form, the report of the company to the Tax Administration with its appendices. These contain a selection from the books, records and other documents with the specific adjustments and calculations required or regulated in the tax laws and regulations.

Tax auditing, of large companies in particular, tends to focus on the correlation between the second (books and records) and third (tax return) sphere, while the first sphere (reality) of the company is neglected. This makes the tax audit *formal*: paying attention to formalities. A tax audit, though, should look behind the figures and accounts and have a strong *material* (or *substantive*) component as well.

The solution for auditing larger companies is to divide the information into *routine* processes and *non-routine* processes. Routine refers to the mainstream work going on within a larger company. The company will have implemented various ways for exercising control. By auditing the internal controls, the tax auditor is able to assess the risks efficiently. In this way more attention can be paid to the non-routine processes, i.e. the exceptions, the unusual.

When auditing smaller companies, attention should be paid to the material aspects. As a small company is usually relatively loosely organized, the internal controls will be irreplaceable. The tax auditor should be aware of this and seek other methods and third party information.

4.1.1.2. Understanding the business

Typology of business

To know how to run a business is to know how to audit a business.

Businesses can be divided into standard types, based on the possible internal controls and correlations within the company. Appendix 6 gives an overview of the different standard types. A rough classification can be: agricultural businesses, mining, wholesale, retail, mass production, unit production, services, based on available space, services with (some) flow of goods, services on a direct time basis, other services, financial services and non-profit organizations. This classification largely determines the type of possible internal controls, the specific registrations, the accounting systems to be expected, and their auditing relationships.

Some examples of these auditing relationships:

Trading companies: There is a strong correlation between what is coming in and what is going out. The purchases plus an average percentage (gross margin) must be the turnover. Sometimes you can even count the numbers of articles going in and going out. After these calculations the auditor must judge the wastes, the lost goods and the discounts: are they acceptable? Sometimes there are internal standards within the company, many times there are standards for specific lines of business.

Production companies: There is no usable direct correlation between incoming and outgoing goods, but with a certain quantity of labour, raw materials and machine hours the finished products are made. You need calculation schemes, cost price calculations, production standards and receipts. Also production reports and internal analyses are usable. The way the company is guarding efficiency is the way to audit. Often there are usable standards for specific lines of business.

Banks and insurance companies: For these companies you can only rely on the internal control and money movement in the company. For an insurance company you can use the relations between premiums and claims. In many countries banks and insurance companies are treated by teams of specialized experts, as the risks and tax amounts are high and expert knowledge is needed to pin-point the fiscal risks and the ways of detection.

Industry information

Industry documentation is important for the selection process and as a support for the audit. What are the processes in this industry? What are the special risks in this branch? Which audit approach is needed? Also, benchmarks of industries are important. Compare the figures of the company involved with the average figures in the industry: specific losses, reductions, correlations and other standards. The best way to deal with this is a system of organized gathering of specific information. The source can be, for example, the tax audits, or the information gathered by the line of industry itself.

An example of the United States:

In the United States the IRS uses Compliance Initiative Projects to identify and quantify areas of non-compliance. They usually involve a study, survey or other analysis of a group of individuals or companies within an occupation, industry, geographic area, or a specific economic activity.

They are undertaken to identify, measure, or analyse compliance with tax laws and to determine if any corrective action needs to be taken. They are often multi-functional and particularly useful for small business taxpayers. Several levels of management approval must be secured before a Compliance Initiative Project can commence.

An example of France:

The auditing of small companies is facilitated by the existence of monographs (statistical studies of certain professions), guides issued by the General Tax Inspection Authority on a specific profession, and a software program called “Synfonie” (used particularly for analysing previous audits), which make it possible to determine average ratios for these companies, thus facilitating the work of the auditor, who can compare the results of the small company that he is auditing with the average ratios corresponding to the profession. This is clearly an initial approach, which the auditor must elaborate on in the course of his work.

Equal treatment

It is important to treat every company within a line of business the same way. If not, companies may base their case in appeal on the interpretation in another case, favourable for them. To keep equality in treatment there can be rules for the various types of industry. These rules can be based on

agreements with industry organizations: which depreciation is acceptable, which costs are acceptable, is there any form of compulsory registration? etc. It is possible to develop statistics by gathering information from a number of companies. Also statistics gathered by other parties can be used.

4.1.1.3. Third party information

4.1.1.3.1. *General observations*

This paragraph discusses the obligations that persons or companies have concerning the levying of taxes on third parties. We will successively discuss who can be subjected to a third party investigation, the gathering of information, passive and active cooperation, and the consequences of refusing cooperation, the position of public accountants, tax consultants, banks, and governmental bodies.

An example of the United States:

In the United States taxpayers occasionally refuse or are unable to provide the information necessary to conduct the examination. In these situations, the IRS has the authority to issue a summons, which is legally enforceable, to either the taxpayer or a third party to secure testimony and/or documents to ascertain the correct tax liability of any person or entity. A summons to secure testimony is used to obtain the taxpayer's admissions, the taxpayer's explanation of transactions and to discover the existence and location of records. A summons for documents is used to obtain the taxpayer's books and records or a third party's books and records related to (a) specific transaction(s) or tax period(s). In the event that the summoned party does not comply with the summons, the IRS can compel compliance through the courts.

4.1.1.3.2. *Types of third party information*

Three types can be distinguished:

- Bulk information that is supplied periodically, in bulk, and often digitally. It will be based on national arrangements. This type of information can often be matched on a one-to-one basis with data in tax returns, resulting in signals or adjustments. The process is known to the public, resulting in correct declarations most of the time. However, if these flows would come to an end, the behaviour with respect to tax returns would deteriorate massively. Characteristically, this informa-

tion is matched with other data and the system in itself ensures correct behaviour.

- Bulk information that, often in combination with other internal and external data, produces a signal that a certain risk exists. For example, the number of driving exams registered by a central organization can be compared with the annual turnover declared by driving schools. This will provide a ratio that can serve as a starting point for selecting risky taxpayers.
- Specific information that can be used for a certain audit. For example, information about a specific transaction.

A good practice of gathering and using information in Spain:

The first category of third party information is applied at a large scale in Spain by gathering information through the so-called Form 347. This gathering of information is the mainstay of fiscal supervision of Spanish taxpayers. Form 347 information has the following characteristics: Each company in Spain is required to submit a statement of his purchases and sales in as far as the value involved in these transactions with individual parties exceeds a certain amount. This statement should include transactions the company made with both other companies and individuals. The company should state the fiscal identification number of each of them. The information is stored in a database and used for matching purposes and for cross-checks with tax returns.

A good practice in Brazil:

To maximize the quantity and quality of the information obtained from third parties, the Brazilian Tax Authorities have developed the Integrated Collection System (Sinco), which is distributed to tax-paying entities whose relevance in the economy, in terms of quantity of transactions and commercial partners, justifies collection of the respective data. As a priority, the system involves data from receipts of purchases and sales and allows the taxpayer:

- to infer data from his accounting system, in various formats;
- to validate his basic data from fiscal registers;
- to compact the data, encoding them for transmission;
- to send the files of the generated data by means of the Internet, creating a digitally verified receipt.

4.1.1.3.3. *Who can be subjected to a third party investigation?*

An important issue is whether a third party investigation can be carried out at every person, company and organization. If so, the next questions are which information can be demanded and whether there is an obligation to retain documents. In most countries legislation obliges companies, business owners and organizations to cooperate in a third party investigation. Usually, private persons only have a limited obligation by law to cooperate and hardly any obligation to keep records and books. They are often only required by law to cooperate for the purpose of their own tax returns.

4.1.1.3.4. *Privilege of non-disclosure*

Most countries have enacted regulations on the privilege of non-disclosure for practitioners of certain professions, in order to protect social functions and positions. As a consequence, the information with which they are entrusted as part of their professional duties is confidential information, which they are prohibited to disclose to others. These “others” frequently include the Tax Administration.

Examples are: medical professions, priests, lawyers, sometimes banks, auditors and tax advisors. In most countries such a privilege cannot be invoked with regard to a taxpayer’s own tax returns, nor can it be invoked to prevent an audit of a company’s own fiscal position. This information will mostly be of no use for third party cases. Legislation often makes a distinction between usable and protected information, for example financial versus medical information. The protected professions and the details of each protection differ from country to country.

4.1.1.3.5. *Third party information*

The main goal of third party information is the use as counter-information. The function, purpose and use of third party information rest on the duty of the Tax Administration to uphold the law. By using such information, risks can be signalled or covered. The information can be in bulk (for example data from banks concerning interest returns) and individual (such as pieces of information on the cash sale of a certain asset).

Two restrictions could apply to gathering and using third party information. First, the burden it creates to business and industry must be kept to a minimum, thus there must be a specific use for the information. Second, it

must be avoided that gathering and using information would distort or interfere with competition.

4.1.1.3.6. *Function of third party information*

The function of third party information is:

- detecting risks and potential fraud;
- prevention;
- ensuring equal treatment.

It is important that good and meaningful information is obtained and prepared. It must be of quality: reliable and having an extra value for the enforcement process. Bulk information will mainly have a preventive effect. Individual items will touch on a tender spot, a fiscal risky event or fact.

4.1.1.3.7. *Supplied and collected information*

Part of the flow of intelligence is processed on a massive scale. Often legislation obliges the providers of information to annually bring the data to the Tax Administration, often digitally. Information can also be collected by the Tax Administration. This can be done during special campaigns, obtaining information in a specific industry, or on an individual basis.

Some examples of the use of third party information.

The Netherlands:

In the Netherlands there was a nationwide campaign on travel expenses: Information of travel agencies was gathered, especially the holiday, honeymoon and other pleasure expenses that were invoiced by travel agencies as business trips. All sorts of information, like invoices, booking slips, tickets and correspondence were collected as proof. Subsequently, investigations were made of the buyers of the travels with suspicious invoices.

France:

France had a similar campaign. Another type of usual campaign concerns the purchase of expensive cars, boats, planes or labour in private houses. These investigations disclose cash payments (undeclared amounts).

The right of inquiry: Investigation services are empowered to undertake investigations in businesses, in order to detect violations to the invoicing and invoicing obligations that must be fulfilled by taxpayers subject to VAT. This procedure allows for unexpectedly intervening among taxpayers, and permits to interrogate the manager. If irregularities are observed on that occasion, they will be cause for a subsequent examination of accounting records.

Argentina:

There are several information systems provided by third parties that allow the tax agency to cross-reference the data on the tax returns against other information received. This procedure can lead to field or desk audit cases, depending on the importance of the taxpayer.

One of these systems is known as CITI COMPRAS and is completed monthly, with the information sent in the form of electronic files (submitted by 6,500 taxpayers) which contain the purchase data sorted by transaction, including the identification of the supplier involved in the transaction. This information accounts for 65% of all tax credits countrywide.

Brazil:

In Brazil, expenses related to doctors, dentists, hospitals, clinics and health plans are deductible from the income tax, declared by private individuals. To do this, the taxpayer incurring the costs will have to provide information, in his annual statement, about the identity of the entity the payment was made to and the amount of payment, and keep the corresponding receipt on file should documentation as proof of this payment be necessary. Private individuals – doctors, dentists, physical therapists, etc. – as well as legal entities that are the beneficiary of this type of income, are obliged to declare such income, while hospitals and health-care plans must also declare the value of payments they made directly to health-care professionals. The Tax Authorities are able to ascertain, by cross-reference of these data, the following risks:

- that a private individual should reduce his taxes due by declaring a fictitious payment;
- that a professional (doctor, dentist, etc.) should neglect to declare any income received;
- that the health-care plan or hospital should neglect to declare any revenue or payment made by it to a health-care professional.

4.1.1.3.8. *Informants*

Sometimes spontaneous information is offered to the Tax Administration. The source of information can be known and open or anonymous.

- If the source of information is known, the information, in itself, is usable. Still one should always wonder why the information was offered. When other reasons are involved, the reliability of the information will be questionable. Ex-wives and frustrated ex-employees will have other interests and tend to exaggerate.
- If the information is offered anonymously, its use is very limited. The value as proof is almost nil. At the most it can be a signal to focus the audit on a specific risk. It should be used with great caution. There are well-known big fraud cases that started with anonymous information, but there are also examples of innocent companies, severely harmed by this kind of information.

In some countries it is allowed to pay for useful information. The payment is often a percentage of the resulting adjustments. Only if a country has specific regulations that allow these payments, use is permitted.

4.1.1.3.9. *Banks*

Banks are often obliged to provide certain types of data, such as data on interest, dividends and royalties. These data are systematically delivered in bulk. Which data must be provided, varies from country to country.

Also, banks can be obliged to provide access to credit files of clients. In these cases, there will be specific legislation, describing in which cases what information can be accessed. Often the procedure requires that attempts should be made first to obtain information through the taxpayer. Often there is specific legislation for combating criminal activities or tax evasion.

Some examples of the use of banking information.

Argentina:

There is a bank information system that must be completed monthly by all banks (about 90 informants) which reports on all payment authorizations above \$ 8,000, sorted by client. This information is filed through an application that was put into effect by an agency regulation.

France:

Within the framework of the right of communication, it is possible to obtain information from banks. Tax rules envisage the collection of all documents held by credit establishments (account extracts, copies of cheques, loan transactions, etc.), without the necessity to obtain authorization from the holder of the accounts mentioned earlier. Each auditor has a database. This regulation is essentially applied when an account audit is performed; this is an examination of a personal tax situation or a control of inheritance declarations. Otherwise, the tax authorities may also access, upon demand, foreign capital transfer operations performed by natural persons or associations domiciled or established in France.

4.1.2. Subjective sources of information

4.1.2.1. Accounting obligations, relationships with nature and size of the business activities

4.1.2.1.1. *What do “books, records and other documents” consist of?*

The legislation of most countries provides for accounting obligations. These obligations can entail a general obligation to keep books and accounts that can be used for several types of tax. Usually, the law also provides for specific obligations with regard to certain types of tax, such as the obligation to keep record of purchases and sales for the levying of value added tax (VAT). Frequently the legal sanction has been created by a shifting or even a reversal of the burden of proof if taxpayers do not comply with these obligations.

The general accounting obligation will require records being kept of the events and activities that are part of the business process. These records should consist of journals (books like the cash book and bank book, purchases journal, sales ledger), converging on a general ledger and occasionally sub-ledgers for accounts receivable, debts and/or stocks.

For smaller companies, the account may consist of a few journals, supplemented by a simple summary statement in the form of a trial balance, which thus is prepared without using a general ledger. There is a clear relationship between the size of the business and the complexity of the books and accounts to be expected. Also, there is a relationship between the nature of the business and the way the accounting obligation is elaborated.

An essential part of the accounting obligations is the requirement that the books and accounts reflect the business process completely and correctly. As was pointed out in the Introduction, this is essentially not an accounting (formal) requirement, but rather a material (substantive) one.

There are also systems in which mandatory (certified) books with pre-numbered sheets must be used. This obligation is in conjunction with a prohibition of removing any of these numbered sheets. Although countries may adhere to these rules, their significance is very limited. Because the mandatory books must, obviously, be impeccable, the company will make an advance selection of what will and what will not be revealed or accounted for. Moreover, this system is outdated in an age of digital books and accounts. Disregarding specific regulations for special circumstances, these systems should be considered obsolete.

In addition to the books and accounts as a record of the financial business events and processes, each company has many other forms of records: quotations, registers of orders shipped, acceptance and approval of goods received, payment orders, production records, stock lists, cost estimates, costing calculations, pricing instructions, price lists, diaries, etc. The list varies according to the type of business. Thus, a distinction must be made between the books and accounts, and the total company records. The legal requirements usually apply to the books and accounts only. Many countries, though, impose limited obligations with regard to the remaining records. These obligations, in particular, concern providing access to records and the related obligation to retain them. With regard to a tax audit, these sundry records are an essential source of information in addition to the company's books and accounts, and constitute an important basis for many audit techniques and methods. These records are created to make the business processes of the company possible, or to make them more efficient or effective. Thus, the company itself is, to a greater or lesser extent, dependent on correctness and completeness of these records. As a consequence, these records usually provide a sound basis for testing the figures and transactions that have been recorded in the books and accounts. Some examples are: weekly planning of personnel versus wage accounts, material issue records versus sales records, delivery lists of drivers versus sales records, the office diary versus the records of services delivered, price lists versus recorded sales, etc. Here too a relationship exists between the records and the size and nature of the company.

4.1.2.1.2. *Relationship between books and accounts and the size of a company*

Small companies keep simple books and accounts. Not only is their number of transactions is small, which makes the various records limited in size, but also their complexity is low and therefore they do not require differentiated records. Moreover, the time and accounting skills of the company's owner will be limited. Thus, a rather uncomplicated accounting system is to be expected. Conversely, it is relatively simple to leave part of the business process out of the books and accounts, as the owner manages his business affairs all by himself. Too much attention paid to the formal aspects of these books and accounts may result in false certainty.

A frequently used legal tool is the obligation to use a cash register and always provide a cash receipt to customers. This requirement may have some, restricted, effect. Enforcement of the issue of cash receipts by the government can only be patchy, the effectiveness of the system depends upon the attitude of the general public. The view and perception of the general public with regard to taxation are essential to this attitude. But even if the public expects to receive a cash receipt, there may be some collusion with part of the customers, like passers-by, tourists, befriended customers, etc. Therefore, complete certainty can never be offered by the system. However, it is better to have some certainty than none at all. In audits and other investigations the technicalities of cash-register entries, cash counts, changing rolls, etc. must also be checked. Numerous are the examples of smart shop owners who in the course of the day count their cash and after that continue to sell products "for their private account". The big hotel can also be mentioned, with six cash registers and a perfect cash organization; however, only five of the six money-flows were present in the books.

A good practice of the use of technical possibilities in Argentina:

The use of "tax cash-register machines" (invoicing equipment that is similar to cash registers or printers) that can issue receipts or invoices has been regulated. The main feature of these units is that they are equipped with an EPROM memory that stores the total amounts sold per business day, along with the taxes involved in these transactions. This "tax" memory cannot be erased and constitutes a basis for estimating the taxpayers' returns. The unit also contains a serial port used only by the AFIP inspectors to obtain the information in the tax memory when needed. This can be done by any inspector who has a notebook computer and the software developed by the AFIP for this task.

As companies grow, separation of functions, specialization, separation of management and ownership are introduced and the need for planning and information increases. In order to keep business events and procedures in hand, internal control measures, internal policies, procedures, analyses, etc. will be developed and put in place. The Tax Administration and the company owner have a common interest to ensure that all receipts are accounted for, and that expenses and investments are classified and entered into the books correctly. But also, some kind of collusion or silent conspiracy may emerge between the company owners, management and personnel against the tax authorities. For example, the personnel planning may present a correct picture, but in the books a different presentation of the business is provided. Or, all sales are accounted for and handed over to the management at the end of the day, but only part of the receipts is entered in the cash book. As a consequence, other records besides the books and accounts become very important in a tax audit. As explained earlier, the knowledge of what records are to be expected depends to a large extent upon the nature of the business.

4.1.2.1.3. *Fixed fiscal rates and amounts applicable to small companies*

As was previously pointed out, the books and accounts are only of limited significance in smaller companies. A method to compensate for this is the introduction of fixed rates and amounts. This is usually done by legislation, allowing to fixate the taxation on one or more simple bases. The level of the fixed amounts or percentage may be established annually. Such regulation may be requested by the company, or may be valid, unless the company's request is for normal levying procedures. Also, the law may provide fixed arrangements for all companies that meet specified criteria. Where fixed arrangements apply a taxable base is needed that is easy to verify and difficult to manipulate. For example, many countries have fixed amounts and rates for hotels and hospitality businesses, like a fixed profit per square metre, per chair or per outdoor chair. Also lump-sum amounts are used: taxi-drivers in large cities, barbers and other small public services. A mixture is the fixed percentage of the sales as the only taxation for shops. The system of obliged cash registration will help in this case. As such, auditing can be limited to the system of invoicing and cash registration, plus receipts.

These fictions appear to be very effective. An additional advantage is that the limited auditing capacity of the Tax Administration can be deployed for other companies. It is wise to study regulations in other countries to

create an easy working system, which fits the specific situation of your own country.

Some examples of the use of fixed fiscal rates:

Spain:

Individual owners of smaller companies pay VAT and income tax, based on certain criteria, such as used square metres, number of employees, used electricity, number of cars, etc.

Argentina:

The fixed rate or simplified regime taxpayers (*monotributarios*) are controlled through special procedures involving the cross-referencing of information from third parties (bank information), leading to the detection of an incorrect categorization of these taxpayers, as well as their exclusion from the regime. This was detected more frequently in the services producing sector.

Brazil:

Micro-enterprises and small companies have the option of paying taxes on a simplified schedule, substituting all revenue and social security duties charged to the company by one single monthly collection. The amount is determined by a table of progressive percentages, ranging from 3% to 9%.

This system of simplified collection is called SIMPLE. Besides SIMPLE, there is an income tax system for companies, based on a projected profit, in accordance with the activities of the company. This possibility encompasses medium-size companies with a total income of up to BRL 24 million, with some exceptions.

Similar regulations exist in many countries:

Greece uses square metres and number of chairs in taxing bars and restaurants. Bulgaria has a fixed rate on taxis. Belgium permits simplified VAT calculations for small companies.

4.1.2.1.4. *Differences between commercial and fiscal balance*

Computing the taxable profit and preparing the fiscal balance sheet are based on the annual accounts of the company. However, there may be reasons for deviating the taxable profit from these accounts:

- In the commercial balance (the one that goes to the banks, the owner, and is the base for rewarding the management) the tendency will be to present a high profit and value, to recognize profit as soon as possible. In a fiscal balance sheet and profit-and-loss account the tendency will be the opposite: to recognize profits not before strictly required. Where different valuation methods are permitted, the tendency is to opt for the method that results in a low valuation. Thus, payment of taxes is deferred, occasionally for one or more years, sometimes virtually indefinitely, for as long as the company will exist in its present size. Therefore, unless regulation forbids the use of different balances, there will be two different balances: a commercial and a fiscal one.
- Fiscal laws and regulations, and fiscal case law, may have their own sets of valuation rules, which may be different from the customary commercial systems. For example, writing down assets directly against the company's equity will not be permitted for fiscal purposes. Also, for taxation purposes any change in the accounting system must be fully accounted for in the company profits of previous years. For commercial purposes it suffices to reflect the influence of the changes in the result of the previous years. Fiscal valuations are usually based upon historical costs, in commercial balances often a valuation at current cost is allowed.
- There are numerous legal limitations to deductibilities on the one hand, and tax credits and exemptions on the other hand. For example, fines imposed by the government are usually not deductible; also certain payments for luxury goods are frequently subjected to restriction in deductibility. Extra fiscal allowances are frequently permitted in order to promote social or economic objectives. Also the one-off levying of tax on companies (or on the holding company, or on the company in which the company participates in the equity) results in tax exemptions.

Tax regulations should oblige a total disclosure of the differences, with amounts and reason for each deviation. This "open reconciliation" will be the basis for the validation, verification and audit risk analyses.

4.2. The toolbox

4.2.1. Forms of enforcement: the tool box

4.2.1.1. Introduction

If a tax return is taken out for further examination, the next question is how intensive the attention must be. Expressed in an ascending order of required capacity: checking tax returns from behind the desk, probably with questions in writing for the taxpayer (verification); a partial audit, a full audit, or a thorough fraud investigation. The choice depends on the reason why the tax return was taken out in the first place. If many tax returns were taken out, particularly because of a specific problem, a standard form for treatment can be attached, ensuring that the problem is recognized by the officer and providing a minimum level of quality.

4.2.1.2. Verification

Checking from behind a tax office desk is a form of treatment, requiring little capacity for each tax return. The tax officer processes all tax returns taken out for further examination. The actual treatment will be decided by the reason for having been taken out and the standard treatment instructions for the deviations signalled.

4.2.1.3. Preliminary agreements

Preliminary agreements include all contacts with the taxpayer on the fiscal consequences of occurred events, or intentions or plans, before they are reflected in a tax return. These preliminary agreements concern the acceptability of the way in which the issue is handled and incorporated in a tax return in the future. They can take place upon the request of the taxpayer, or can be initiated by the Tax Administration.

This tool can only be used if parties are mutually willing, and have the legal possibility to make binding agreements. The willingness on the part of the Tax Administration is associated with the degree of reliability of the taxpayer. The legal possibilities differ from country to country. In many countries the Tax Administration can or wants not to be bound legally by agreements.

To clarify: These agreements always concern the interpretation of the tax laws; what will be accepted and what will not be accepted. Hence, they are always within the existing tax laws. Any interpretation “over the edge” must be avoided.

The advantages of preliminary agreements to both parties are:

- The company obtains certainty. The problem in the tax return will be dealt with as agreed, and any other treatment will certainly result in actions by the Tax Administration. Companies consider the entire issue of taxation as a side effect of their business activities, as a complicating factor in their plans and decisions. Certainty about the fiscal consequences is therefore welcomed.
- The Tax Administration frequently encounters strong resistance if the manner in which events have been reflected in the tax return must be corrected. Both parties take up their positions, and a battle ensues in the form of negotiations or legal procedures. The way in which the contested event is processed in the tax return is an indisputable fact, and any adjustment results in an additional levy. In early discussions the differences of opinion are less intense, the company is primarily uncertain, and it is easier to agree on the fiscal consequences, so that at a later stage problems will be avoided.

The nature of the issues of preliminary agreements varies. In many cases they are about streamlining the fiscal consequences of intended decisions, in which third parties, such as employees, have an interest. For example, a new pension scheme for the staff, a new reimbursement system, etc. Also, matters that become irrevocable in a later stage may be initially discussed, such as the obligation to retain digital files, the organization of certain parts of the accounting system, the way in which intra-company costs are settled, transfer pricing, etc. Moreover, companies need and appreciate timely certainty with regard to important decisions for which unanticipated fiscal consequences may prove to be disastrous. For example, management succession, financing large acquisitions, far-reaching restructuring, and (again) transfer pricing (APA's).

A good practice in the United States:

The IRS has implemented the Pre-Filing Agreement Program. This programme permits a taxpayer to request the examination of specific issues relating to a tax return that has yet to be filed. This programme also estab-

lishes a framework within which the taxpayer and the IRS can work together in a cooperative environment to resolve the examined issues. A pre-filing examination can often resolve such issues more effectively and efficiently than a post-filing examination because the taxpayer and the IRS have more timely access to the records and personnel relevant to the issue. A pre-filing examination also provides the taxpayer with a greater level of certainty regarding the examined issue at an earlier point in time than a post-filing examination. Thus, the use of pre-filing examinations benefits both taxpayers and the IRS by improving the quality of tax compliance while reducing its costs, burdens and delays.

A good practice of formal consultation in Brazil:

A formal consultation, presented and answered in writing, in an administrative process, for the purpose of interpreting and explaining the tax legislation. In this case, the taxpayer is protected against the possibility of intention discrepant from the manifest one in a response to this consultation, at least until the manifest intention of this response has been rectified by another decision from the Tax Authorities.

Preliminary agreements include a certain risk that tax officers take a wrong decision, with important consequences for the future. The cause may be their lack of experience and insight, resulting in an underestimation of the problems. Another cause can be a lack of distancing from the company (organizational myopia), or even a lack of integrity. Both risks can be reduced by requiring fixed procedures to be followed, agreements to be concluded by at least two tax officers, and only valid after being confirmed in writing by superiors or a third specialist. Moreover, a system of job rotation of tax auditors, specialists and account managers is required.

4.2.1.4. Observation on site

An “observation on site” is a visit to a company in order to acquire an up-to-date picture of reality. The observation on site is not meant to achieve immediate auditing results. However, the conclusions from an observation on site may induce an examination of books and records at a later date. During the observation, agreements can be made for improving the behaviour of the taxpayer with regard to his tax returns, improving the accounting system, or the retention obligations. These data and agreements may serve as a standard for the treatment of the company in the future.

The primary objective of an observation on site is gathering current data:

- gathering data on the extent of the activities: capacity, business hours, closing time, number of staff required, side activities;
- counting the number of staff present. The obligation to present ID-papers may be invoked;
- collecting lists of prices, rates and tariffs;
- assessing the organization of cashes, including any cash counts;
- stock-taking of the inventory and the range of products;
- assessing the accounting records, and the compliance with the retention obligations.

The way an observation is done can be standardized for certain lines of businesses.

As a Tax Administration is not a police department, an open-sighted approach towards the taxpayer is usually preferable. Within an open-sight approach every observation on site will start with the tax officer identifying himself to the taxpayer. It will also be a good habit to send a copy of the internal report afterwards to the taxpayer. Exceptions on these rules will need a special reason.

A “visual survey” is an observation on site involving no contacts with the company. It can be made both from inside the company and from the public highway. As the tax officer does not identify himself during his visual survey, his activities can easily be perceived by taxpayers as being sneaky, and thus in contravention with the open-sight approach. Thus, there must be a special reason justifying this type. It may be considered:

- if there is a reasonable chance of disturbances when the tax officer identifies himself. Example: amidst a large public audience. In such cases the tax officer shows his ID at the earliest suitable moment, and informs the taxpayer of the facts he has observed;
- if there is reasonable safety risk involved for the tax officer;
- if it is virtually impossible to contact any company officers at that moment, for instance when observing the activities of a taxi company or a driving school.

There must be a legal basis giving the Tax Administration the competence to carry out an observation on sight. Such regulations can stipulate which rooms may be entered at which moments, and what limits must be observed in the observations. It is important that an observation on site is implemented correctly and uniformly, as it will give the organizational

framework considerable weight. The preventive nature of the observation on site and the policy of openness are paramount.

Many countries have special departments for this kind of observation. As the techniques need special skills and as the number of trained auditors is limited, separating the observation on site from the usual auditing can be a good idea. A problem then will be the organizational distance between the special department and the auditing teams. Good and regular communication must be arranged.

An example of on-site observations in Brazil:

On-site observations are conducted by proceedings to verify situations that do not directly indicate probable illegal fiscal transactions, or to solicit information from third parties. In addition to fiscal intelligence work, which is usually carried out without identification of the public servants involved, it is common for auditors to visit establishments belonging to taxpayers or to third parties in order to solicit or confirm information that could indicate whether or not an inspection procedure is called for.

4.2.1.5. Visit to the company

Visiting the company can be a tool. It involves a meeting with the owners or executives, either upon the request of the company or on the initiative of the Tax Administration.

This tool fits in a policy of proactive approach of taxpayers. The objectives of a visit are:

- Reviewing current fiscal matters. Large companies in particular are constantly confronted with fiscal intricacies, resulting in debates, queries, objections, etc.
- Gathering information about the current state of affairs in the company. This information will be both on general developments impinging upon the company and certain, specific events of fiscal relevancy. For example, a recent acquisition, a restructuring, a major investment, important changes in the management of the company, etc.
- Assessing the situation of the company (the observation on site aspect of the visit).

Of course, it must be prevented that an informal visit to a company is arranged without concrete reasons or results. The visit consumes valuable

time for both parties, and the taxpayer sometimes has invited expensive assistance of external consultants. In practice, this tool appears to be effective only if sufficient reason is given for a meeting.

4.2.1.6. Visit to starting companies

A special form of a visit to the company is the visit to a starting company. Particularly with regard to starting businesses many aspects can be adjusted early while observing the current conditions on site, including the accounting system. Fiscal issues common to the industry can be discussed, and special procedures in the fiscal treatment can be pointed out, such as observations on site, audits and investigations, the consequences of late tax returns or payments, etc. Also, a first impression emerges on the reliability of the company and its owner. Visits to starting companies serve a double purpose: enforcement and providing service. It will be clear these services should first of all prevent future problems. Of course only real new starters need to be visited, not the new subsidiaries of existing companies.

Some good practices in the approach of starting companies:

Canada:

Starting companies are visited within a year and a half after the start. The visits are meant to be preventive and for collecting risk information.

The Netherlands:

About 40% of all starting companies are visited for the reasons mentioned above.

A CART-based risk model determines which companies are selected. This model takes into account: line of business, income, family income, properties, gender, age, nationality and past behaviour. It can reasonably predict which companies need extra attention.

4.2.1.7. Partial audits

A partial audit is an examination of books, records and other documents, in which only a specific (fiscal) risk is investigated. It is also known as an “issue audit”. For example, the valuation of only one balance sheet item or the correct application of a specific fiscal regulation. Essential to a partial audit is the limitation concerning the scope of the audit, which is

announced in advance and registered in the report afterwards. As a consequence, all rights are reserved with regard to any aspects that have not been examined.

A partial audit enables targeted and planned examinations to be carried out. The subjects and items chosen are the product of centralized risk assessment and selection as described in Chapter 3.

An effective use of this tool requires the right tax regulations. Existing principles of law may create obstacles to its use. These obstacles, though, are not caused by the partial audit itself, as it is up to the Tax Administration to decide what is examined and what is not. The obstacles emanate from the competences of the Tax Administration to institute an investigation and to correct any aspects that have not been examined. These competences may have to be surrendered. Many countries have a system in which an examination of books and accounts closes a certain period of time, to which the Tax Administration is not authorized to back-track. In such a system the Tax Administration has one chance only to audit a period. A partial audit would thus result in forfeiting all rights of the Tax Administration with regard to the non-examined aspects. Such a regulation has usually been introduced to create clarity to the person being audited. That clarity is important. The scope of a partial audit must be clear in the announcement, the execution and the report. A regulation that prevents correcting any non-examined aspects at a later instance hampers a risk-oriented approach. It forces the Tax Administration to always examine all relevant risks, or to make choices, thus forfeiting its rights with regard to non-selected risks. The system of audits closing a period will have been altered into a system in which the Tax Administration is able to assess different risks at different moments.

Some good practices in partial audits:

France:

The partial audit (called “flash audit”) can also be required whenever a speedy intervention is necessary, as in the case of:

- special circumstances (ceasing of activities, legal proceedings, customs requirements as regards VAT);
- estimated risks identified as a result of a desk audit are limited to a specific aspect;
- selected VAT refunds (new businesses, short duration companies, risk sectors).

The partial audit can also concern a limited period (one month or one term). All taxpayers' rights must be respected, and the method is adapted to the limited context of a flash audit.

Instituting partial audits requires understanding and acceptance of this tool by the auditor.

It requires also a good team leader, who has to organize the work, to estimate the risk and to decide between a regular or a partial audit. In order to avoid any misunderstandings with the taxpayer, the audit notification sent to the latter before the commencement of the procedure mentioned earlier indicates very clearly the period and the taxes that are the object of the audit.

The United States:

The IRS has developed an audit process referred to as the Limited Issue Focused Examination (LIFE). LIFE is a streamlined and accelerated examination process that was designed to ensure the most productive use of examination resources by focusing on tax returns where compliance risk is the highest.

In a Limited Issue Focused Examination, only the issues that have the most material impact on tax liability are examined. In most cases, limiting the number of issues selected will serve to compress the time span and enable the IRS to devote sources to the other critical programme areas.

The process of conducting LIFE is a fairly simple concept that incorporates the use of a full-risk analysis to identify the critical few issues on a return. LIFE provides the option of eliminating some of the mandatory compliance and examination steps that are currently required on every examination. The process requires the establishment of materiality thresholds during the planning of the examination.

While the examination process is to a degree inherently adversarial, both sides have a common interest in completing it timely, efficiently and fairly. LIFE requires that the taxpayers share in the responsibility for completing these examinations. A key requirement of the LIFE process is that taxpayers sign an agreement which addresses the key aspects of the audit including the filing of claims.

4.2.1.8. Full audits

The “fullness” of such an audit does not refer to all possible risks being investigated. It means that, within the limitations of the available time and possibilities, the largest risks are dealt with. There are always restrictions with regard to the available time. As a consequence, the risks with the largest financial importance will be given the highest priority, plus any risk that can be investigated with little effort.

In many countries the full audit is the traditional procedure. The other methods are relatively new, and are considered exceptions to this form of auditing. As systematic risk analyses become better and more extensive, and as thinking in terms of risk by tax officers develops further, full audits may become the exceptional alternative to the usual partial audits. In small companies there are usually only a few single risks of importance. Here the difference between a partial audit and a full one blurs, and thus it may be more efficient to always institute full audits.

A full audit shall be necessary when there are many risks and questions about the taxpayer.

A good practice in France:

If in an ordinary audit concealment of sales should come to light, the audit is not terminated and transferred to another service, but the auditor can be helped with a special procedure: the right to visit and of seizure, which is a right to search on the part of the tax authorities. This right of visit and search can only be exercised in the event of a strong suspicion of direct tax and VAT fraud (professional activity).

This procedure thus enables visits to all professional and private premises and the seizure of all documents and files that may be used to establish material proof of fraud. Only certain auditors have the legal capacity to implement this procedure. Hundreds of proceedings of this type are presented annually in the most important cases of tax fraud.

4.2.2. Auditing process

4.2.2.1. Introduction

The auditing process comprises the following stages:

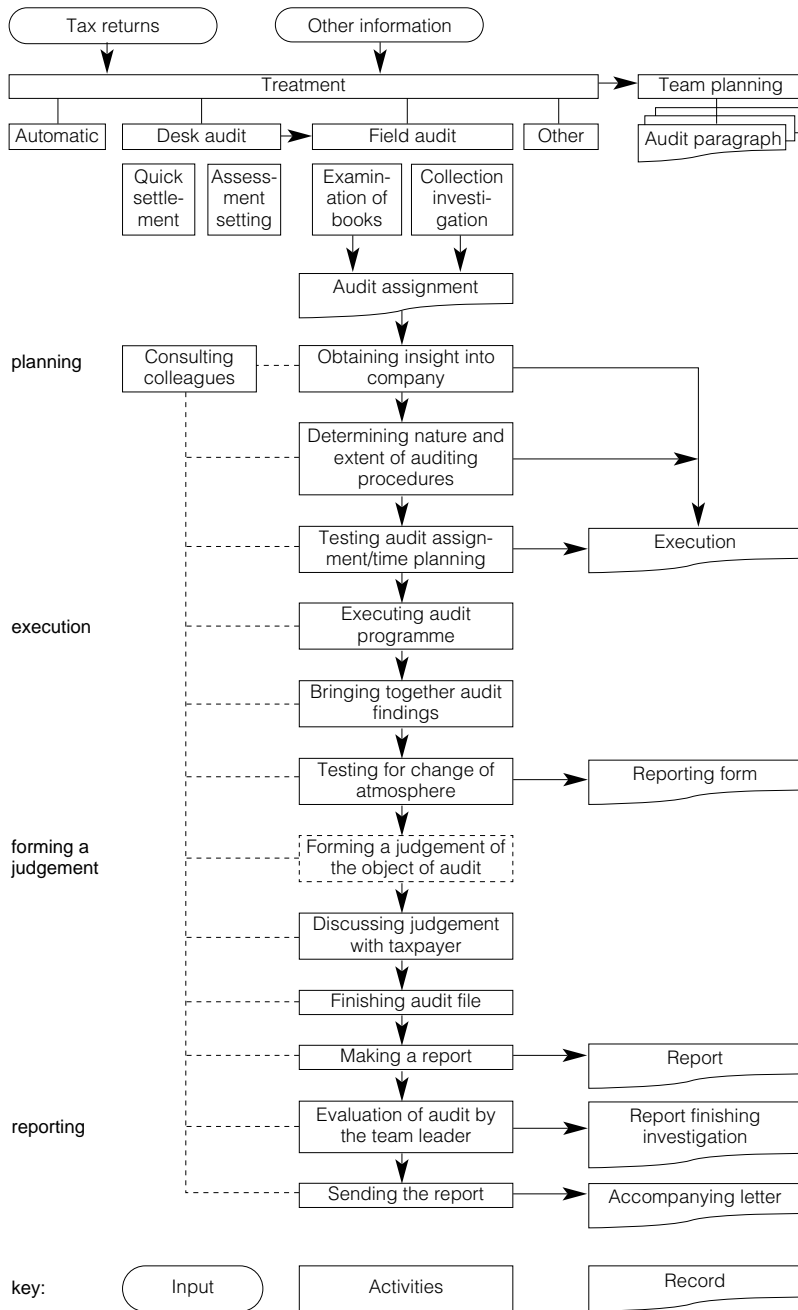
Stage	Description	
1	planning	translating the audit assignment into an audit programme
2	execution	executing the audit programme
3	forming a judgement	summarizing the audit findings and forming a judgement on the basis of these findings
4	reporting	reporting for the purpose of providing information that may be important to the levying and/or collection of taxes

Each stage builds upon the results of the previous one, and thus structures the entire auditing process. The results can also lead to adjusting the procedures that have been carried out in a previous stage.

The following diagram provides a summary of the auditing process and its main stages. For each of the stages an overview of the procedures to be carried out is given. The tax auditor makes a record of these procedures and conclusions to be included in the audit file.

Chapter 4 - Tools to support examination and audit

Diagram: The principal stages of the auditing process

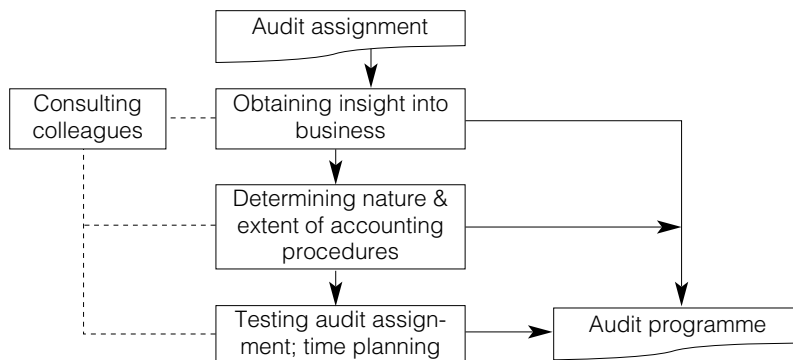


4.2.2.2. Stage 1: Planning

Planning the audit

Preparing a plan is essential for structuring and carrying out an effective and efficient audit. In order to make such a plan, insight is required into the business process of the taxpayer, and into the industry or line of business he operates.

In the first stage of the auditing process a programme for the audit is made. The starting point is the audit assignment as this states the object, as well as the objective of the audit, and thus the area to be covered by the audit programme. The tax auditor records the results of the planning activities in an audit programme.



All decisions that are taken in this stage of the auditing process, and all data and considerations on which they are based, are recorded and included in the audit file.

The procedures in the planning stage include:

- gathering data on the company;
- making a preliminary analytical review;
- making a risk analysis on the basis of the data the tax auditor has gathered for and derived from the preliminary analytical review;
- testing the audit assignment on the basis of the results from the preliminary analytical review;
- preparing a time schedule for the procedures on the basis of the estimated time required for the audit.

On the basis of the results of these procedures the tax auditor is able to establish:

- which sub-objects he has to check (e.g. work in progress, self-assurance accounts, expenses) in order to make a judgement of the object of the audit as a whole (e.g. the tax return);
- how thorough the check of each sub-object should be;
- which effective and efficient mix of auditing procedures should be carried out in order to gather the information he needs for making his judgement;
- what the contents of the audit assignment finally will be; and
- how he will plan his time.

By carrying out the auditing procedures that are included in the audit programme, the tax auditor obtains the information he needs for making his judgement. This is called the audit evidence. The auditing activities should constitute a solid foundation for a sound judgement on an audit object. A solid foundation is achieved by knowing the subject, and an appropriate depth and coherence of the auditing procedures. This means that a system of auditing procedures must be determined in a professional fashion that is both efficient and effective. Depth must be based upon risk analysis: the extent of the procedures depends upon the fiscal impotence, the fiscal risk, and the relationship between the expenses and the proceeds of the audit.

Carrying out the preliminary analytical review

Before a tax auditor can start preparing his auditing programme, he must gather data on the taxpayer to be audited. These data may already be known to the Tax Administration, or may be obtained from the taxpayer. The tax auditor will subject the data gathered to a preliminary analytical review. To this end he arranges, classifies and analyses the data. He searches for links and relationships between the data.

From all available data he tries to derive various connections, trends, points of special attention, and questions that must be dealt with by the audit. He also takes into consideration information on the basis of which the entity/tax return was selected for an audit.

The preliminary analytical review does not only use quantitative data, but also qualitative information.

The auditing of very large companies often has a phase of analyses and a phase of auditing the selected fiscal risks. The first phase, the preliminary analyses, will be a precursor to one or more partial audits.

In this preliminary or explorative phase a rough analysis is made of the annual figures at the head office of the company or group of companies. It includes an analytical review of the consolidated annual accounts, an analysis of the reconciliation between commercial and fiscal annual accounts, and a summary review of the annual accounts of subsidiaries and establishments. Conspicuous matters can be discussed with the controller of the company or groups of companies. This analysis will result in the selection of one or more aspects. Specifying and examining these aspects will be done under the heading of a partial audit. This approach creates clarity and makes it possible to complete a risk analysis in complex situations. Moreover, in this way the scarce expertise within the Tax Administration at the highest operational level can be used as efficiently as possible. The limitations and assumptions of a partial audit described above equally apply to this approach.

An example: A preliminary phase is instituted in an oil company X with many establishments across the country and subsidiaries in the whole of South America. In this preliminary phase it emerges that striking losses were incurred in the extraction activities of two establishments. It also came to light that exploration in the Gulf of Mexico generates high, non-taxable profits. Subsequently, both matters are defined for a partial audit and investigated further.

Risk analysis at the level of a tax return

In determining which procedures should be carried out in order to achieve the objective set, the tax auditor constantly watches the costs/benefits relationship of the tax audit.

One tool for determining which procedures should be carried out, is the risk analysis. For the selection process a risk analysis was already carried out at the level of the taxpayer base. In preparing the audit programme an additional risk analysis is required, i.e. a risk analysis at the level of the individual tax return. For this analysis the tax auditor uses the data he has gathered for and derived from the preliminary analytical review. On the basis of these data he makes a more detailed estimate of the probability that, given the purpose of the audit, the tax return contains material inac-

curacies. He records the elements on which this estimate is based. He will include these elements in the auditing procedures.

It is possible – and even likely – that he will have to adjust the risks estimated up-front on the basis of the information that becomes available during the audit.

Testing the audit assignment

On the basis of his findings of the preliminary analytical review the tax auditor will test his audit assignment. To this end he assesses whether, and if so, how the audit assignment should be adjusted. In addition, he assesses whether his knowledge and skills are sufficient to carry out the audits adequately. The audit assignment may be changed after the team leader has been consulted. In some cases it may be decided, after consulting the tax officers involved, that it would be appropriate to hand over the audit assignment to another tax auditor. If it has been decided to adjust the audit assignment, the considerations leading to this decision are recorded in the audit file.

Announcement of a tax audit

In most countries it is customary to announce the tax audit to the taxpayer. These announcements serve to clearly inform the taxpayer of the extent of the tax audit, and must eliminate the impression of a surprise attack.

If it has been decided to adjust the audit assignment, and the taxpayer had already been informed of the extent of the audit, he must be informed immediately of the changes. Good communication with the taxpayer contributes to avoiding the taxpayer having other expectations than are justified on the basis of the audit. The extent of the audit will also be laid down in the report.

The tax auditor will complete this stage of the auditing process by recording the results of the planning activities in (a first draft of) the audit programme. The audit programme includes the various audit objectives, consisting of:

- the (sub-)objects the tax auditor has to check in order to arrive at a judgement of the audit object as a whole;
- the criteria against which the various sub-objects should be tested;
- the nature and extent of the auditing procedures that will be carried out for each tax tool.

The audit programme has two functions. Prior to the audit it provides direction to the auditing procedures to be carried out; afterwards it makes it possible to evaluate the procedures carried out (quality assurance).

An example of a very strict audit mandate in Brazil:

Tax operations and tax guides

In the model adopted by the Brazilian Federal Tax Authority, which is characterized by previously prepared spot tax action, irrespective of how many audit points need to be checked, the scope of an audit process is delimited when the taxpayers are selected for inspection.

Since the selection is based on technical parameters, the tax inspector receives this information on the scope of the inspection in the form of one or more tax operations, which are sets of correlated audit processes which, in turn, are documented in detail in tax guides. Therefore, the tax inspector knows, on receiving the tax audit process mandate, what the organization expects him to do, the manner in which he must conduct his investigation and the formal and material aspects to be observed in respect of any summons. Thus, the scope of the audit is very well determined, but there is no flexibility left for the auditor and very little initiative is permitted.

4.2.2.3. Stage 2: Execution of the audit programme

In this stage of the auditing process the tax auditor implements the prepared audit programme. This audit programme provides the routes along which the audit will progress. The information that becomes available during the execution of the audit may show that the audit programme prepared before the audit started should be adjusted. From the new information the tax auditor may, for instance, conclude that one or more elements have not been considered or have been considered erroneously in the risk analysis.

In addition, it may become clear during the execution of the audit that the auditing tools are not applicable or sufficient, or that, for this particular audit, better results could have been obtained from other auditing procedures. In such cases the tax auditor will have to adjust the audit programme. Adjustment of the audit programme can entail an extension or a reduction, depending upon the new information. Preparing an audit programme is thus not a static, but an interactive and dynamic process.

In technical terms of both the auditing and the fiscal perspective, the tax auditor must be aware of the limits of his knowledge and skills. Before,

during and after the auditing procedures he must ask himself whether consulting specialist colleagues or calling in their help would be necessary. Consulting specialist colleagues ensures that the audit leads to a better judgement on the tax return. It also results in improved quality of tax audit. The tax auditor includes in the audit file all decisions and the data and considerations on which these decisions are based.

Good practice in benchmarking in France:

Benchmarking is possible before the audit and during the audit with software called OASIS. This is a general risk assessment on a whole population, a segment or a cluster of taxpayers. It allows selection of taxpayers for audits. It analyses main elements of tax returns, for quick assessment and first level audit.

OASIS is also a multi-purpose flexible tool:

- a database extracted from VAT, income tax and corporate tax returns: VAT, profit and loss statements, and balance sheets;
- fresh VAT data every month;
- open to local tax processors, auditors and risk assessments teams;
- assessment models can be adapted to local needs.

OASIS eases selections:

- possibilities of horizontal, vertical and ratio analyses;
- users can implement existing criteria and ratios or create new ones;
- criteria are derived from past experience;
- three main categories: unusual tax return behaviour, changes of fiscal behaviour, risk-associated sectors.

OASIS deepens analysis:

- after the selection of one or several taxpayers, OASIS provides an automatic financial and fiscal analysis of each tax return;
- OASIS provides ratios and comments and constitutes the basis for a first level audit.

4.2.2.4. Stage 3: Forming a judgement

At this stage of the auditing process the tax auditor collects and summarizes the audit findings, and forms a judgement of the tax return on the basis of these findings.

There are two possibilities:

- there are no reasons for the Tax Administration to take any further action; or
- the results of the audit are cause for appropriate measures. These usually entail making adjustments which may or may not be accompanied by the imposition of a fine and/or arrangements for the future.

After the concluding meeting and the determination of the Tax Administration's position the tax auditor finishes the audit file. All records are given their final place in the file. Thus, an easily accessible file is created providing insight into the preparation, execution and results of the audit.

4.2.2.5. Stage 4: Reporting

The objective of this stage is to provide information that may be important for the (future) levying and/or collection of taxes. Thus, the tax auditor prepares an audit report in which he carefully and clearly lays down both the assignment and the results of the tax audit. By sending a copy of the public part of the report to the taxpayer, and by filling in the statistics form, the auditing process has been concluded.

An example of an infringement document in Brazil:

Conclusion of the audit process: infringement document

After conducting the audit processes scheduled, and if these reveal tax irregularities, the tax inspector must officially calculate the tax payment due by means of a document known as an infringement document.

This document observes legal requirements to allow, on the one hand, the taxpayer summoned to have full knowledge of the facts attributed to him by the audit, including and mainly the legal device infringed and, on the other hand, the public authority to make an administrative or judicial collection of the payment due.

To implement this summons, the tax inspector has two computerized systems which allow him, in an integrated manner:

- to investigate and prove values involving the tax owed: a task performed by a working document system, or inspection document system, which provides a technical pattern for proving infringements, regardless of who the tax inspector in charge of the case is;

- calculation of legal increases and issuing of the infringement document, with the records provided by the tax inspection and indication of the legal devices infringed.

4.2.3. The auditing concepts and techniques

4.2.3.1. Technical concepts

4.2.3.1.1. *Completeness and correctness checks*

Taxpayers do not enjoy having to pay too much tax or pay it too soon. This has consequences for the direction of the auditing process with respect to the different parts of the audit (balance sheet items, sales, labour costs and such). There are two approaches:

- correctness checks: checking whether what has been reported and accounted for should indeed be reported and accounted for. It deals with correctness;
- completeness checks: check whether all that should be reported and accounted for has indeed been reported and accounted for. It is directed at completeness.

Whether the examination of an item needs to be aimed at correctness or completeness depends upon the interest the taxpayer has in the way the item is accounted. The nature of a particular item itself is not relevant for the decision. Assuming that the taxpayer does not want to pay too much tax or pay it too soon, the interests of the taxpayer mean that in general:

- assets are more likely to be undervalued than overvalued. The direction of the audit will be completeness;
- liabilities are more likely to be overvalued than undervalued. The direction of the audit is then correctness;
- revenue reported in the profit and loss account is more likely to be too little than too much. The direction of the audit is completeness;
- costs reported in the profit and loss account are more likely to be too high than too low. The direction of the audit is correctness.

4.2.3.1.2. *Formal and substantive checks*

By means of a formal check the auditor establishes whether a taxpayer has complied with the rules and regulations. Other forms of formal checks are tests directed at the arithmetical correctness and the numerical relationship

(for instance between the amount of an invoice and the amount entered in the books).

By means of a substantive check tax auditors establish whether or not the various elements of the business process have been recorded correctly and properly. Quantitative analyses and existence checks are substantive checks.

The various objects of an investigation are frequently tested for both formal and material aspects.

4.2.3.2. Audit approach

4.2.3.2.1. *Introduction*

During an investigation the tax auditor collects information on which to form his judgement. This information is called “audit evidence”. The auditor obtains audit evidence – for each audit objective – by carrying out auditing procedures. Collectively all auditing procedures for the various audit objectives are called “the auditing mix”. The auditor records the procedures in the audit programme. Each application of an audit technique aimed at obtaining audit evidence is called an “auditing procedure”. The method by which the audit evidence is collected, “the audit approach”, determines the nature of the auditing procedure(s) concerned: data-oriented, organization-oriented, etc.

An audit approach is a well-considered way of carrying out auditing procedures. This is also called an “auditing method”.

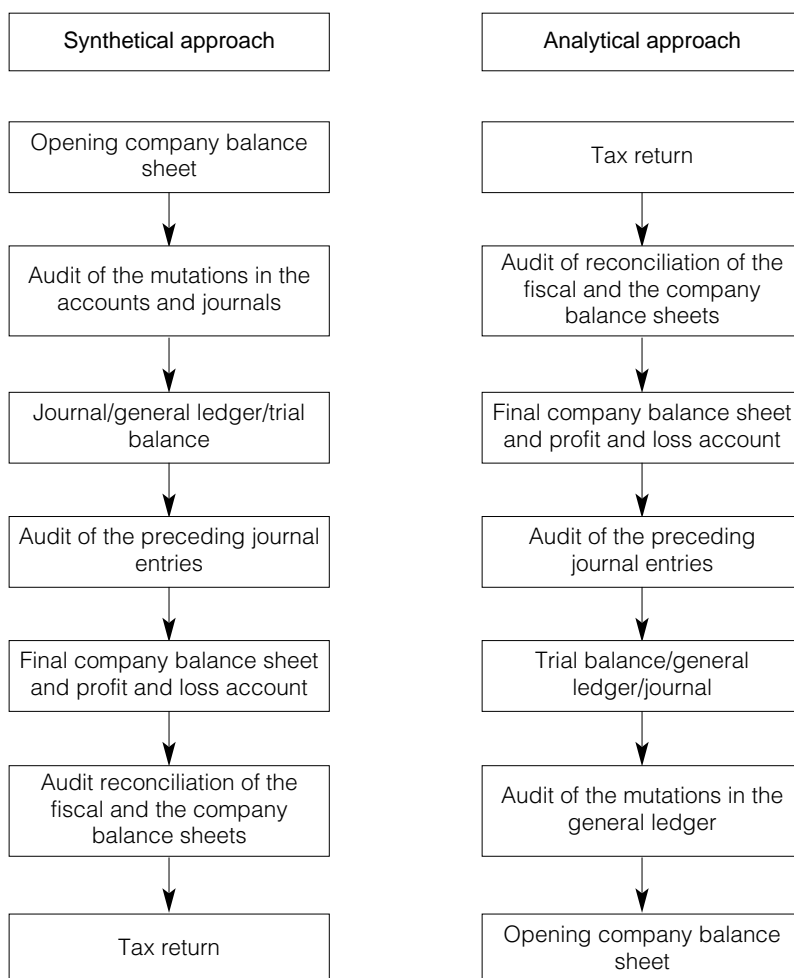
To achieve the audit objectives different approaches can be followed:

- the synthetical approach (also: progressive procedure);
- the analytical approach (also: retrogressive procedure);
- the data-oriented approach; and
- the organization-oriented approach.

The tools and means with which the auditor collects audit evidence are called “audit techniques”.

4.2.3.2.2. *The synthetical and analytical approaches*

This figure illustrates both approaches (from top to bottom).



In the synthetical approach the auditor follows the same path as is used for deriving the figures for the tax return. In the analytical approach the course follows the opposite direction. In other words, in the synthetical approach the auditor follows the route from prime data to tax return; for the analytical approach he starts with the totals of the tax return and works back to the basic data (or details) in as far as he considers this necessary. It is not

always necessary, though, to follow each step of the synthetical approach through the books and accounts. In addition, the auditor may want to process the prime data to the totals himself; he can then compare his results with the figures in the tax return.

The analytical approach is, in general, less labour-intensive than the synthetical approach. The reason is that in the analytical approach the auditor will use quantitative analysis wherever possible.

With regard to the synthetical and analytical approaches the following should be kept in mind:

- For the application of both approaches the auditor must know how reliable the internal entries and the external documents relevant to the investigation are. To what extent it is possible to form a judgement on the reliability (and the completeness!) of these documents depends largely on the effectiveness of the internal control system.
- This approach starts with the details, but this does not imply that every detail must be checked.

Where possible the auditor may use (total) correlation checks.

4.2.3.2.3. *Data-oriented approach and organization-oriented approach*

Every company has an internal organization. The accounting organization and the measures for internal control are part of this internal organization. Usually, this combination is referred to as the AO/IC. The accounting process reflects the (results of) business processes, for instance, in the form of sales reports, balance sheets and profit and loss accounts. The reliability of these outcomes depends upon the effectiveness of the structure and functioning of the AO/IC.

If the auditor wants to establish the completeness and/or correctness of a certain outcome by testing the corresponding data, he will follow a data-oriented approach. If the auditor wants to determine the effectiveness of the structure, of the implementation, and of the functioning of the AO/IC through which the outcomes are obtained, his approach is organization-oriented. This is an indirect way of arriving at a judgement.

The auditor will depend on the AO/IC in his investigation, if:

- it is technically feasible, because the auditor can check whether the structure, the implementation and the functioning of that AO/IC is

(sufficiently) effective. Depending on his judgement, the auditor may limit the execution of the data-oriented auditing procedures;

- it is efficient. This is the case, if forming a judgement on the structure, implementation and functioning of the AO/IC (through organization-oriented procedures) requires less time than performing data-oriented procedures.

If the taxpayer uses computerized data-processing systems, the following approach may be used:

- auditing around the computer;
- auditing the computer processing.

“Auditing around the computer” is often data-oriented. An organization-oriented approach may also be used if the auditor can rely on the AO/IC “outside the computer”. The approach, in which the computer processing is audited, is organization-oriented. This is the domain of the EDP auditor.

The approach the auditor selects may vary with the objective of the audit. The audit programme of an examination of books and records (i.e. a results-oriented investigation) includes therefore both data-oriented and organization-oriented auditing procedures. In addition to being data-oriented or organization-oriented a specific auditing procedure can also be synthetical or analytical.

4.2.3.3. Audit techniques

4.2.3.3.1. *Introduction*

Audit techniques are tools with which the auditor collects audit evidence. The following techniques can be distinguished:

- making comparisons;
- making calculations;
- requesting information and/or access to books, records, documents and other data carriers;
- verifying facts through external documents and/or internal records;
- carrying out procedures on random samples; and
- making observations on site.

These are basic techniques which can be applied in many ways. They are also used in various combinations, all of which are called “audit techniques”.

A particular way to make comparisons is to compare items with (or testing against) standard data. Ways to request information and/or to obtain access to books, records, documents and other data carriers include:

- third party investigation;
- requesting information from the taxpayer being audited; and
- requesting access to the audit file of the public accountant.

Particular ways to verify facts through external documents and/or internal registrations include:

- reconciling entries in the accounts with invoices; and
- reconciling entries in the accounts with information collected from third parties, who may or may not be other taxpayers (so-called “intelligence”).

In general, documents from outside the company are more likely to be “reliable” and “objective” than internal records. Techniques that are a combination of basic techniques include the analytical review, (total) correlation check, stock taking, check of origin, expiration checks; capital comparisons; and chi-square testing.

4.2.3.3.2. *Quantitative analysis*

Quantitative analyses are carried out by applying the following audit techniques:

- analytical review or a testing analytical review;
- (total) correlation check;
- testing items against standard data;
- capital comparison; and
- chi-square test.

4.2.3.3.3. *Analytical review*

The analytical review is an economic analysis and interpretation of series and groupings of figures which have been prepared in advance. An analytical review is, in general, more meaningful if the data are edited and prepared. Eliminating extraordinary items (e.g. detracting speculation profits from the operational results) and reducing various quantities to a common denominator (monetary terms) are forms of preparation.

The value of an analytical review for the examination depends, amongst other things, on the reliability of the data that are associated with one

another in the analysis. Internal control provisions can be an important way of preparing data, provided they sufficiently ensure the reliability of the data. It is typical for the analytical review that making an analysis goes hand in hand with interpreting the outcomes.

Economic analysis and interpretation involve:

- establishing correlations, establishing relationships or monitoring developments;
- interpreting these connections, relationships or developments against the background of theoretical standards, empirical standards or data from outside the company or the economic unit;
- looking for explanations of the existence, or indeed the lack of, a connection or relationship or the occurrence of a particular development.

Thus, an analytical review comprises a chain of procedures. Finding correlations may be part of it. An analytical review must not be confused with a correlation check. In the latter procedure it is presumed that a correlation does exist. Also, testing against standard data can be part of the procedures within an analytical review.

The analytical review that is being carried out to obtain audit evidence is called the “testing analytical review”. In addition, there is also the “preliminary analytical review”. This type of analytical review is no part of the quantitative analysis, as it does not produce audit evidence. The preliminary analytical review is intended:

- to obtain a general impression of the contents of the tax return;
- to identify sub-objects that need to be audited;
- to signal conspicuous developments;
- to signal changes in the nature of the operations;
- to extend and/or to update the auditor’s knowledge of the company. On the basis of this knowledge the auditor assesses the inherent risk;
- to signal problems that may affect the continued existence of the company.

This list shows that the preliminary analytical review is aimed at both quantitative and qualitative aspects. The preliminary analytical review helps in determining the contents of the audit programme and can provide a list of questions for the introductory meeting. The forms a preliminary analytical review may take include:

- comparisons with previous period(s);

- ratio analysis: balance sheet items and/or items in the profit and loss account are related to each other. Examples are the gross profit margin and the turnover;
- trend analysis; the auditor establishes, on the basis of data from previous periods, whether or not the figures show a particular trend. If they do, the auditor extrapolates the figures from the past to the period under review. He compares the amount to be expected on the basis of the trend with the actual figures from the tax return;
- comparison with other companies.

How will the analytical review help the tax auditor?

The real skill of auditing is not to check A with B, C with D, etc. The “art” of auditing is only to check what is wrong. Try to limit the work by analysing the available figures and, after that, focus on what is unlikely and what is probably wrong. This will make the audit much more efficient and effective. Many techniques are involved, as described before. However, which technique and to which extent in each situation is needed is very difficult to explain. An experienced auditor will, after some analyses, within short time know what to focus on as he recognizes patterns and relations. Choosing what *not* to audit is also a process of experience. A beginning auditor is likely to audit all parts, as he does not want to miss possible adjustments. After auditing the unlikely several times, and concluding that all the work hardly results in any extra detected adjustments, he will be more prepared to choose not to audit the unlikely. In some cases auditing the unlikely will give unexpected results. These patterns and situations will be added in the personal analyses techniques. Hence the use of analyses is very important, but difficult to teach.

4.2.3.3.4. *Correlation check*

The correlation or association check is an assessment of the completeness and/or correctness of data by linking these data to other data. The auditor compares what has been recorded in the accounting system (the factual position) with his calculation of what should have been the case (the normative position). Correlation checks are almost always applied to totals, and are thus a form of quantitative analysis. In exceptional cases only may a correlation check have the form of a test of details.

The value of this audit technique for the examination depends upon:

- the reliability of the series of figures and the positions from which the auditor starts. The auditor must, therefore, assess the correctness and completeness of these starting points; and
- the validity of the correlation. The auditor needs to establish whether the presumed functional relationship indeed exists.

If these conditions are met, the correlation check provides strong audit evidence. In a correlation check the auditor calculates a normative position. Comparing the factual position with this *independently established* normative position is not the same as testing against standard data.

For the correlation check the auditor may use standard data. This is, for instance, the case if he uses an industrial recipe (standard data) to determine how much of a final product (the normative position) should have been manufactured with the materials that have been consumed.

4.2.3.3.5. *Testing against standard data*

Sources of standard data include social and economic life (for instance, laws and regulations), economic science and the company itself (for instance, its budgets). These data are not established by the auditor himself. A distinction can be made between standard data that are valid in a general sense, and standard data that are only valid for a particular company (specific standards). Some general standards are provided by the law, for instance the tax laws and regulations. Other standards are ratios, such as gross profit margin, that apply to an entire industry.

Specific standard data may be derived from the articles of association and contracts, budgets and estimates, and industrial recipes and predetermined costs.

The value of the application of this audit technique for the examination depends, in particular, upon the reliability of the standard data (the auditor has to know how the standards or standard data itself are derived at), and whether the standard is valid in a particular situation. The auditor has to be aware of the purpose for which the standard has been developed. For instance, the gross profit margin that applies to a specific industry is of a general nature. The situation of a specific company within this industry may deviate to such an extent from the general rule that this gross profit

margin is not so applicable because, for instance, of its highly unfavourable location.

4.2.3.3.6. *Capital comparison*

Capital comparison is a technique that focuses on the assets, liabilities, income and outlays of the taxpayer.

All possessions of a person or family at the year-end, minus all possessions at the start of the year, is the amount of money gained in some way over the year. All known sources of income, taxable and not-taxable, of the year are calculated. This money can go in two directions: consumption by the taxpayer and his family, or possessions that still exist at the year-end. Consumption can be on known private expenses, like paying rent and schooling, etc. The rest of the consumption is spent on household expenses.

Thus, all possessions on day one, plus all sources of income, minus all possessions on the year-end, minus all known private expenses, will give the money spent on household expenses. These “net private withdrawals” are tested against the amount that, on the basis of social and economic standards, should be expected. If the outcome of these calculations is low, or negative, then there must have been an unknown source of income.

This technique can help to discover hidden sources or profits.

4.2.3.3.7. *Indirect methods*

There are several calculation methods to evaluate and recalculate the turnover and profit of a company. These methods are not based on the existing bookkeeping, but are recalculated indirectly. For example, from purchases to turnover, using industrial information and standards. In many countries these methods are of use when there is proof that the bookkeeping is not reliable.

Some examples of the use of indirect methods in the United States:

The IRS uses five basic indirect methods to reconstruct income.

The Bank Deposit Method analyses all bank deposits and all expenditures paid by cash and check. This method computes income by showing what

happened to the taxpayer's funds. The sum of all taxable deposits plus all cash outlays equals total income. The Source and Application of Funds Method analyses the taxpayer's cash inflow and outflow for a given period. Excess expenditures over the known sources of reported taxable and non-taxable income is deemed to be unreported income. The Net Worth Method compares beginning and ending net worth for a taxable year. The increase in a taxpayer's net worth adjusted for non-taxable income and non-deductible expenditures will result in taxable income. The Percentage of Mark-up Method reconstructs income using percentages or ratios considered typical for the business under examination. By reference to similar businesses percentage computations are secured to determine gross sales, cost of sales, gross profit and net profit. The Unit and Volume Method determines gross receipts by applying price and profit figures to the volume of business done by the taxpayer. The units of volume of business done by the taxpayer are determined from either the taxpayer's books or records or from third party sources.

A good practice in the Netherlands:

The chi-square test can prove, through statistical procedures, whether a cashbook contains fictitious entries. Scientific research leads to the conclusion that every person has a certain preference for, or aversion to, certain digits. When a person is asked to write down random a list of numbers, e.g. the number 8 may be more frequent and the number 3 may be less. With statistics the chance can be calculated that the resulting list of digits was random. Manmade lists of digits turn out to have a change of close to zero that they were random. Thus a proof can be given that the numbers were fictitious. Especially daily sales in a cashbook can be subjected to this test. If the sales are fictitious statistics will prove it. One condition has to be fulfilled: there should be enough figures available to produce a statistically usable outcome. Roughly one year of daily sales will provide a usable outcome. In court the chi-square method can provide an extra proof, it will not stand when it is the only proof, but it will help as part of the total evidence.

4.2.3.3.8. *Testing of details*

Testing of details is the data-oriented auditing procedure of separate entries. Although these tests focus on specific entries, they are intended to ascertain the total amounts of particular accounts. Therefore, either all entries are checked (full observation), or the number of observations is

limited (partial observation). An audit technique that is frequently used in a details test, is verifying facts with external documents and/or internal recordings. Sampling is also usable.

4.2.3.3.9. *Existential check*

If, within a data-oriented approach, an existential (or existence) check is used, it is considered a details check. The existential check seeks to establish that what the books and accounts pretend, or imply, indeed exists. The audit techniques that are used for existential checks include:

- stock-taking; through his personal observation the tax auditor establishes the existence of items such as goods (including cash), supplies, equipment, facilities and vehicles;
- expiration checks; the auditor determines whether a specific balance sheet item has been liquidated or settled at the end of the financial year. If this item has been liquidated or settled, it follows that it must have existed earlier. An example is the receipt of an amount that was included in the balance sheet as a receivable. An expiration check also provides insight into the value of an item. Thus, it is, for instance, less probable that a receivable was properly marked down, if an expiration check shows that the nominal amount was received;
- the check of origin; the auditor establishes at which moment in time a balance sheet item came into being. The auditor may, for instance, establish when items on a list of accounts payable were created by checking the invoices concerned. If he finds invoices from the previous financial year, the amount on the balance sheet for the item “accounts payable” is too high.

4.2.3.3.10. *Completeness of net receivables*

By carrying out an expiration check for the net receivables in the (first months of the) next year, the auditor is able to establish the completeness of the balance sheet item “receivables”. If he finds invoices from the preceding financial year, he must conclude that the amount on the balance sheet for the item receivables is too low.

4.2.3.3.11. *Procedural test*

All audit techniques with which the auditor wants to establish the existence and the effectiveness of the internal control measures intended to

prevent, or to detect and correct important errors in the tax returns and/or company annual statements, are called “procedural tests”. Procedural tests are organization-oriented auditing procedures. A procedural test may consist of:

- gathering information;
- verifying facts from documents;
- carrying out observations on site;
- establishing whether a particular action has (probably) been undertaken by checking initials, etc.;
- processing items independently; and
- checking data.

In assessing the functioning of the internal control system the auditor may also want to use analytical review, correlation checks and testing against standard data. If the auditor applies these audit techniques within the context of an organization-oriented approach, they constitute a procedural test.

CHAPTER 5

SPECIAL ASPECTS

5.1. EDP audit

5.1.1. Introduction

The rapid developments of the past few decades in the area of computerization and its applications in accounting have a major impact upon the way in which Tax Administrations must structure and organize the enforcement duties. Traditional processes linked to the exchange of information on paper will gradually disappear. Paper books, records and documents will be replaced by invoice data transmitted electronically through data links and recorded on electronic data carriers. Books and accounts will no longer be kept in the same country in which a company is established.

All these changes make adjustments to examination necessary. A different approach also opens up new opportunities, because the application of information technology may result in more effective and more efficient procedures. In order to implement this different approach the organization must have highly educated and trained specialists in the area of auditing and verification in a computerized environment. The number of these specialists needed, will also greatly increase.

When the Tax Administration wants to use electronic data of the taxpayer, legislation is necessary to have access to this data. The data should be delivered in a form that is readable and comprehensible, showing clearly the nature of the transactions, and their tax liability. This requires not only the books and records being retained, but also the computer software with which the books and records are created. This, in fact, constitutes an extension of the obligation by law to retain books and documents.

Corporations with an accounting system must have also the obligation to take additional measures to ensure that certain software programs are able to convert accounting data into a readable and comprehensible form. As the obligations to both keep and retain books and records are essential to the obligation to provide information, sanctions for non-compliance with these obligations must be provided for.

5.1.2. Development of EDP auditing

Some worldwide trends influence the development of EDP auditing, particularly those of digitization, internationalization, and e-commerce.

5.1.2.1. Digitization

We are on the eve of a society that will change dramatically as a result of information technology. Digitization will have major consequences for this society, and thus for Tax Administrations. The pace of trends that have emerged in recent years will undoubtedly accelerate. It is undisputed that information technology will develop logarithmically. The costs of computerization will decrease at the same pace. Such decreases in costs will make automation a common tool in small and medium-sized companies. For example, within the countries of the European Union even now 70% to 80% of companies keep their books and accounts electronically. A practical consequence for Tax Administrations is that basic registrations concerning the business activities will only be electronically accessible. The audit of such bookkeeping requires different qualities and abilities of tax auditors.

Familiar processes related to the exchange of information on paper will disappear. Modern technology will create opportunities to operate independently from time and place. The application of developments such as the Internet, trading through electronic media, video conferencing and electronic mail are already broadly used. New business models are emerging, such as Application Service Providers and application hosting,¹⁰ data warehousing,¹¹ purchase cards,¹² ERP environments,¹³ but also auctions

10. Books and records are often completely kept by third parties through the Internet. The implication is that the entire company depends upon the way processes in these third parties are organized.

11. Data is recorded and retrievable through the Internet or an intranet, independent of the location of the user. There is no transparency of where data is located. The user organization on a fixed location is heavily dependent upon the organization at a different place.

12. A new method of payment in which an external organization, usually banks or similar institutions, fully or partially take care of the invoicing process.

13. Large, integrated, and complex computerized environments in which an individual organization is heavily dependent upon external consultants.

through the Internet, online shopping portals,¹⁴ joint purchasing through the Internet (web procurement and exchange sites), and bartering.¹⁵

5.1.2.2. Internationalization

Digitization reduces the importance of geographical distance all over the world. Borders of countries fade and disappear. International trade will grow further. Through a network of communication satellites every place on earth will be directly accessible (real-time online).

Companies will become increasingly interwoven, not only through legal ties, but also through economic relationships. Even now the accounting departments of companies use systems of other companies that are not part of their “own” entity.

Interrelationships exist across the entire value chains. Where the (electronic) books and accounts are located is unclear. In internationally operating corporations the location where accounting systems (computer systems) physically are kept and retained is not determined by national borders, but by economic and fiscal motives.

5.1.2.3. E-commerce

Digitization opens up many opportunities for electronic trade (commonly referred to as e-commerce). Through e-commerce a company can trade all over the world only requiring an investment in a computer with a telephone or Internet connection. E-commerce thus provides new opportunities for tax evasion and new forms of fraud. This development should further urge Tax Administrations to exchange information across borders.

14. Orders are not processed directly by the supplier and delivered to the customer, but intermediaries on the Internet are used.

15. Because no direct linkage exists to the flow of money, it may prove difficult to supervise, or even to obtain insight into transactions. Also, to determine the fiscal value may be a problem.

5.1.3. The place of EDP auditing with a Tax Administration

5.1.3.1. Introduction

EDP auditing is part of, and thus strengthens the process of, enforcement as a whole, and of tax auditing in particular. To achieve this objective, EDP auditing assesses the provision of information within an environment in which information technology is applied. Assessing the provision of information is aimed at achieving certain auditing objectives and to optimize examination. Essentially, the auditing approach of an EDP auditor of a Tax Administration is no different from that of an investigation by an external EDP auditor.

The EDP auditor of a Tax Administration carries out auditing procedures in the area of “automation and control”. The EDP audit contains the following *principal tasks*:

- forming a judgement of the structure and the functioning of data processing systems used by taxpayers;
- guiding and supporting auditing procedures of tax specialists by providing computerization tools;
- signalling timely new developments in the area of information technology and to find and formulate appropriate responses within the auditing approach; and
- coaching other EDP auditing specialists.

EDP auditing within the Tax Administration can be divided into auditing procedures and consulting activities. From a technical point of view, a distinction can be made between investigations into the organization and audit automation. These two concepts can be defined as follows:

- (1) An organization investigation consists of:
- charting computerization as a whole, aimed at:
 - making an outline of its auditability and reliability;
 - assessing the complexities of its auditing;
 - advising on the structure of an audit, specifically with regard to the use of auditing software; and
 - establishing safeguards for data recording and conversion, and making data available;
 - investigating a specific information system, aimed at:
 - establishing its contribution to the auditability and reliability of the user company;

-
- advising on the structure of the audit, specifically with regard to the use of auditing software;
 - establishing safeguards for data recording and conversion, and making data available; and
 - establishing possible consequences of the system for fiscal issues;
- (2) Audit automation includes:
- advising on and supporting the application of general automation tools;
 - advising on the application of specific automation tools that are, or may be, available in a company; and
 - applying auditing software, in as far as specific knowledge of computerization is required.

5.1.3.2. Products of EDP auditing

By performing its principal tasks, EDP auditing results in the products which are described below from the perspective of tax auditing. The activities are an integral part of the auditing process. The objective is to enable the EDP auditor to support the examination process in a broad area. This support is, in particular, aimed at enhancing the efficiency and effectiveness of the implementation of enforcement processes.

(1) *Preliminary investigation*

The “preliminary investigation” entails taking stock of the information technology applied by the taxpayer. The thoroughness of the preliminary investigation may vary from making an inventory of the information technology of the company to a conditional investigation. A conditional investigation is an investigation that, in principle, establishes whether or not a company can be audited and, if so, whether an audit can be completed within a reasonable period of time.

With regard to information technology, such an investigation should determine how the information technology and the internal control of the taxpayer interact. An assessment is made whether, and if so to what extent, the irreplaceable internal control measures depend upon the information technology. In addition, the EDP audit assesses which supportive role information technology has in the area of information management within the company.

Some products of a “preliminary investigation” can be considered “a partial preliminary investigation”. They include an investigation into the compliance of the obligation to retain books, records and other documents, as well as the investigation into Electronic Data Interchange (EDI). Within an EDI system all data of orders and invoices are exchanged electronically.

(2) The relationship between risk analysis and the quality of the information technology

Following the preliminary investigation, the EDP auditor consults the tax auditor before formulating some mixes of auditing procedures that can be used as alternatives. For each of these mixes it is stated what the EDP audit will contribute to the procedures. Thus, it should be established what pre-information can be derived from EDP auditing. The advice of the tax auditor can be supplemented by a system audit by the EDP auditor himself, or by a review of a system audit carried out by a third party.

(3) System audit of standard software

System audits are not only carried out on the individual systems at the taxpayers, but also on standard packages of software providers. This standard software includes applications developed by software companies that are used by (large) groups of taxpayers, as it is more efficient to investigate software to be used at its source, i.e. the producer of the software, and to make the findings available for use in investigations mentioned above under 1. The scope of such an investigation may vary from a limited check, to if and how Auditfile (see: good practice in 5.1.5.4.) has been built in, to a complete system audit.

(4) Data gathering and data conversion

Which data is to be gathered and converted follows directly from the planning stage of the audit. In the preliminary investigation it has been established which electronic data of the taxpayer can be used in the EDP audit. The job of gathering and retrieving data may be assigned to one of the members of the EDP auditing team. The outcome of these activities is incorporated into the preliminary investigation. In general, this addition has no consequences for the amount of time to be spent on the audit. In exceptional cases further investigations are required to have data available for auditing purposes.

(5) Data analysis

Which data to analyse and how, also follows from the planning stage. This analysis delineates what can be achieved with the available data and what not in a specific audit. Some examples of specific instruments of this analysis are:

- audits of the completeness and correctness of meta-data;¹⁶
- audits of the completeness and correctness of data that has been transferred; and
- selections, random samples (a-selective), and data mining techniques.

(6) Transferring knowledge in the execution of audits (which may include their evaluation) through the computer

The use of a computer in a tax audit is pre-eminently the field of the tax auditor. This area includes generating available data and comparing factual situations with normative ones. Whether, indeed, tax auditors will apply these tools depends on their knowledge and experience. EDP auditing has an innovative and supporting role with the objective to transfer knowledge.

(7) Specific support of tax audits

“Specific support of tax audits” refers to assessing and/or constructing and applying models which support tax auditing procedures. The EDP toolbox is exploited in consultation with the persons performing the auditing procedures. Making internal data available is part of this class of instruments and services. Examples are: providing processed data from nationwide databases, and transforming and providing certain interim products in order to obtain faster user interfaces.

Good Practice Standards by the European Community

Below is a description of the auditing process as it was established in a conference held in June 2000 in which EDP auditors of all EU Member States participated.

16. Meta-data are data on the meaning of other data. For instance a set of figures has as its meaning “a general ledger account”; another set has as its meaning “an amount of money”.

The process of computer auditing

(1) Planning

- The EDP auditor should work with the other members of the audit group to create an audit plan.
- The EDP auditor will plan the EDP audit to address the objectives of the overall audit.

(2) System mapping. The EDP auditor will establish:

- what data is available in the system and how it is accessed;
- inputs and outputs, and the connections between different parts of the systems;
- data reliability, including the controls maintained over the system, the internal controls and system validation;
- available trader documentation of the system.

The EDP auditor will document the system using the available information and appropriate techniques. The EDP auditor will confirm that the information documented is accurate, relevant and a useful representation of the system's revenue processing, calculations and controls.

(3) Evaluation of system

The EDP auditor will evaluate the system to determine revenue strengths and weaknesses.

(4) Develop test strategy

The EDP auditor will consider the aims of the audit plan, the strengths and weaknesses of the system, the available resources, and decide on what is to be tested and how.

(5) Data capture

The EDP auditor will specify and obtain data from the company for testing, with the aid of conversion and audit software.

(6) Validation

The EDP auditor will confirm the accuracy and completeness of the data against the declarations.

(7) Execute test strategy

The EDP auditor will test the accounting data to detect and quantify errors and ensure compliance with system controls, producing exception and control reports as necessary.

(8) Report on EDP audit

The EDP auditor will produce a final report in accordance with the law of the Member State. The report may include system operation, work done, findings and recommendations.

(9) Future action

The EDP auditor will monitor the implementation of the recommendations, and evaluate the outcome.

5.1.4. EDP auditing and the organization

5.1.4.1. Introduction

The specialist field of EDP auditing as part of the enforcement policy of the Tax Administration is characterized by scarce capacity and very advanced expertise, as well as by rapid developments, the complexity of IT issues, which is still increasing, and cumulating technical aspects of both auditing and EDP auditing. When embedding this expertise and their processes in the structure of the organization, attention must be paid to matters such as education and training (of both EDP auditors and non-EDP auditors), acquiring and transfer of knowledge, developments in the discipline (including statistical methods and auditing standard software packages), and consulting management on the EDP toolbox to be used and the investment the instruments require. In addition, measures must be taken to optimally deploy and utilize scarce EDP auditing capacity.

A factor to be considered is that regular tax auditors are increasingly proficient in both auditing and computerization. The influence of information technology on the tax auditing environment, however, also increases rapidly, making the information technology more and more complex. For assessing the impact of IT on tax auditing requires support of the separate specialist discipline of EDP auditing, as the whole area has become too broad and too profound for expecting all tax auditors to be competent in it.

5.1.4.2. Organizational provisions

Dealing with the characteristics listed above must be at the core of the organization. A centralized implementation of EDP auditing is necessary for as long as the developments are as turbulent as they presently are, and

officers for this specialized area are scarce. A centralized approach is required in view of the following factors.

Technical aspects of EDP auditing

An appropriate organization for EDP auditing requires a professional framework which can be used for reference with regard to standards for assessments (“what”) and execution (“how”). In the development and maintenance of these assessment and execution standards, it is recommended to organize them centrally. Developments in the area of information technology, auditing, tax auditing and EDP auditing are part of the discipline and techniques of EDP auditing. EDP auditors should inform their Tax Administration of these developments, and translate these developments into policy propositions, including assessment and execution standards, and practical applications. In doing so, they should formulate the constraints with respect to the other characteristics. Monitoring the quality of products and instruments is a major issue to be considered.

With regard to the characteristic “discipline and techniques” two more functions must be considered: the application of statistical audits, and auditing standard software packages:

- The statistical auditing function advises on the application of statistical methods and techniques in auditing. It includes charting the influence of quantitative methods and techniques on the methodology of auditing, resulting in both descriptions and standards. The relationship with the characteristic “discipline and techniques of auditing” itself results, on the one hand, from the need to use EDP auditing instruments in drawing samples and, on the other hand, from auditing methodology. The possibilities statistical auditing offers for describing and prescribing auditing methods are indispensable in describing and prescribing methods and techniques for EDP auditing.
- The objective of auditing standard software packages is to identify the influence of standard (software) packages on possibilities and constraints of performing the EDP audit for the benefit of EDP auditing specialists and other tax auditors. During the investigation of the information technology various aspects of software are assessed. For purposes of effectiveness, the IT investigation is occasionally executed at the companies that have developed the software or by service providers. The results of such IT investigations also have an impact on the national level, and can be used in audits of the buyers of these packages.

IT toolbox

Through his knowledge in the area of computerization and auditing, the EDP auditor is pre-eminently capable of exploiting the opportunities that information technology offers for implementing tax auditing. These officers thus use the IT tools and instruments intensively. It is essential that, in doing so, they take advantage of the opportunities various taxpayers offer. The tools and instruments include both hardware and software, as well as matters such as training and education. EDP auditors prepare proposals on the EDP toolbox to management, paying attention to the competences required.

Training and education for EDP auditing

The rapid developments in the area of IT necessitate taking special measures in order to ensure that the knowledge of EDP auditing within the organization is maintained at an appropriate level. The transfer of the advances of general professional knowledge and insights into the practice of ADP auditing is realized by a combination of training and education, written exchange of knowledge, consultation during professional activities, and on the job training. These processes are geared to actual needs through coaching and quality management. The demand for training and education for EDP auditors is both for the education of (new) EDP auditing specialists and of computer EDP auditors.

Capacity for EDP auditing

EDP auditing is a young specialist field within the discipline of tax auditing that is still on the verge of many developments. Expertise is scarce and developments are rapid. At various levels measures must be taken, particularly concerning acquiring and retaining personnel, training and updating professional skills, and making the broad group of tax auditors familiar with EDP auditing.

With regard to the previous issue, a number of levels can be distinguished within the auditing process:

- (1) regular auditors;
- (2) computer (EDP) auditors;
- (3) EDP auditing specialist;
- (4) EDP auditing manager.

Regular auditor

The regular auditor should have a basic knowledge of IT standards, have a basic knowledge of the most common software packages, and be able to interpret their output. The regular auditor should also be able to use basic analysis tools, for example, MS Excel, MS Access and other computerized audit supportive tools, as well as basic tools for office work.

Computer (EDP) auditor

The computer (EDP) auditor should be competent in new technology and middleware systems, including standard and tailor-made systems. The auditor should be able to analyse, obtain, convert and validate EDP material for auditing purposes using a special computer program for data analysis. The auditor should be able to create and run their own routines necessary for checking the specific controls and weaknesses found during individual audits. The auditor should also be able to use analytic tools like ACL.

EDP auditing specialist

The specialist should be capable of operating the latest technology and the most complex integrated and tailor-made systems. The specialist should provide technical expertise and support to regular EDP auditors. In addition, the specialist should contribute to the development of computerization and analysis software for auditing to be used by the other auditors. The specialist advises management on the development of quality assurance policies and technical issues.

Non-technical EDP auditing manager/policy makers

The EDP audit manager or policy maker needs to understand the skills, abilities and limitations of the three previous groups in order to use resources to their maximum effect and to understand the impact of their decisions on the computer auditor/auditing function. An EDP auditing specialist must be able to perform this job.

5.1.5. Application areas of EDP auditing

5.1.5.1. Introduction

Concerning the deployment of EDP auditing within a Tax Administration, three levels can be distinguished. The largest companies are dealt with

individually by an EDP auditing specialist. The job they are expected to perform requires too much expertise to delegate it to any other auditing specialists. Medium-sized to large companies are preferably dealt with by a computer EDP auditor with the possibility of calling in the support of an EDP auditing specialist. Finally, in a small company auditing time is too limited to deploy an EDP auditor. For this category the EDP auditor's task is restricted to training and coaching auditing specialists.

5.1.5.2. Tasks within the EDP auditing process

The tasks of the planning process for EDP auditing are shown in the following table. In addition to the tasks to be performed, the table indicates the knowledge required and the level at which the EDP audit should be carried out. The EDP auditing process for two different target groups is described in sections 5.1.5.3. and 5.1.5.4.

Process stage: planning

Tasks	Knowledge	Regular auditor	Computer auditor	Specialist auditor
Where appropriate, the EDP auditor must contribute to the overall audit plan at the earliest possible stage	– Standards and procedures	–	M	H
Establishing the area of the audit and its objectives	– Insight into sector/ regime operations, risks and controls – IS risks and controls	H	H	H
Reviewing available information and resources available for the implementation of auditing procedures	– Where to find information – How to obtain it	L	M	M
Determine resources required for carrying out the audit	– Standards and procedures – Where to find resources – Responsibilities	L	M	H

Chapter 5 - Special aspects

Tasks	Knowledge	Regular auditor	Computer auditor	Specialist auditor
Having initial discussions with the company on the system and the audit	<ul style="list-style-type: none">– Awareness of IS management, organization and organizational controls– Awareness of development methodologies/ standards	L	M	H
Preparing the audit plan and timetable, and agreeing upon responsibilities	<ul style="list-style-type: none">– Standards (content and format of plan)	M	M	M
Obtaining approval of audit plan	<ul style="list-style-type: none">– Standards and procedures	M	M	M

H, M or L, under each of the levels of officer, indicates the extent to which the task is carried by that category of officer; H = high, M = Medium, L = Low.

5.1.5.3. Medium-sized and large companies and the deployment of EDP audits

The emphasis in the deployment of EDP in audits at medium-sized and large companies is on the planning of the audit and the preliminary investigation. This includes the gathering of necessary data, to convert these data and to perform a first (risk) analysis of these data. In the planning phase it is important to understand the business: what hardware and software is used. Are the normal organizational measures of the company also applied in the IT environment? Are there any back-up and recovery procedures?

The EDP auditor must pay special attention to issues such as providing electronic information and keeping and retaining (electronic) books. In order to allow the work to be done, it is essential that information is digitally provided by the company.

5.1.5.4. Small companies and the deployment of EDP audits: Auditfile and Clair

It is not possible that (scarce) EDP auditors support every audit of small companies, and it is evident that an audit could be more effective if a tax auditor would obtain the accounting data of a company in a computerized form. This is now possible, especially as the vast majority of small and medium-sized companies now use standard financial software. Therefore, auditing specialists must possess the basic skills for tax auditing in a computerized environment. The training and education programme for computerization and auditing must provide those skills.

An example, EDP-audit and small companies in the Netherlands:

Digital tax audits with Auditfile and Clair

With Auditfile, a standard format, and Clair, a versatile operating program, the tax auditor possesses powerful tools to do his audits more efficiently.

Auditfile is a standard data set which, in principle, can be incorporated into any accounting software package. It includes the data that as a minimum is required for each (substantive) audit. With Clair (an acronym standing for “Clear look at information retrieved”), those data can be easily accessed and processed.

What exactly are Auditfile and Clair and what use are they to the tax auditor? The Auditfile is a format which converts all general ledger entries of a particular year (or of several years) into a form with which the tax auditor can work. The Auditfile format makes the presentation of these entries independent of the computer program – the financial software – on which the accounting system of the company is based. In short, Auditfile is a standardized instrument for retrieving data on entries from financial accounting systems. Printouts on paper are no longer required. We have contacted all suppliers of accounting software known to us, requesting them to incorporate Auditfile in their software. To date four of the major software firms have agreed to do so.

The Auditfile module works very simply. Upon request of a tax auditor the company can prepare the Auditfile with one click on a button. This option can also be used by the tax consultant of the company or by an external chartered accountant. The Auditfile comprises the entry data of the entire

accounting system of the company over a particular accounting period. The result of this conversion is delivered in digital form.

Clair processes these data. It is a general computer program for processing and analysing accounting data that make the Auditfile of a company accessible to the tax auditor. In principle Clair does not alter the source files. The only thing Clair does, is “accessing” the files of the company. What are the benefits of Auditfile and Clair to the company and to the tax auditor?

Through Auditfile and Clair the accounting data of a company becomes available in a structured fashion. From these data the tax auditor is able to make selections in a uniform format, independent of the accounting package the client/taxpayer uses. In short, the digital programs take over the routine and time-consuming procedures, while the intelligent and creative work remains the province of the tax auditor. In this way, he has more time available for the real auditing tasks.

The Auditfile module also has benefits for companies. By providing part of their books and accounts in digital form the audits are concluded faster, thus making their contacts with the Tax Administration more functional. Converting the data and transferring it to the Auditfile relieves the Tax Administration from having to ask the taxpayer questions on the accounting package he uses. What is especially important to the company, is that it can more easily comply with its legal obligation to provide access to its accounting system. It is for such good reasons that Dutch employers associations have emphasized that the application of the Auditfile module results in a reduction of the administrative burden of companies. Although the Auditfile offers them numerous benefits, companies are not obliged to purchase the module.

5.2. Exchange of information and international mutual cooperation

5.2.1. Introduction

The international exchange of tax-collection information is an increasingly vital key factor in aiding tax authorities to carry out their examination duties in an effective manner, thereby ensuring fair application of tax laws on an international stage where globalization is the order of the day.

It is becoming increasingly difficult to control tax evasion without the aid of information on economic events occurring partially or fully outside of the national boundaries, involving people residing abroad and possessions in other countries. Tax authorities all over the world are dealing with the recurring nightmares of transfer costs, tax havens, misuse of treaties, lack of funding, e-commerce and others. By helping each other, these agencies will be able to share and receive timely and reliable information, without which their specific control duties turn into an easily missed moving target.

The exchange of information on an international level can take place informally, that is, with no conventional agreement, basically in a spirit of courtesy or solidarity among countries. Notwithstanding the usefulness of this type of arrangement, it is hobbled by the fact that it does not have a proper legal foundation, it is sporadic in nature, it is not formally documented and it is subject to all of the internal legal limitations and good will of the country providing the information with regard to its timeliness, completeness, and manner in which the information is supplied. Under these circumstances, there is a widely accepted need for international cooperation agreements, which provide the signing states with access to information that would otherwise be out of their reach, using internally available means and sources.

Nevertheless, it should be mentioned that the relevant tax information may not necessarily be obtained through the mediation or even the intervention of a foreign Tax Agency. If an inspector needs information on a foreign subsidiary during the course of the tax inspection of a parent company, or while auditing a local subsidiary, he would like to obtain information on a foreign parent company, the company undergoing the inspection may find itself obligated – depending on the country's laws and regulations – to supply information that is in the hands of the foreign company (subsidiary or parent of the local company).

5.2.2. International regulations

If the information to be collected is insufficient within the country of origin of the Tax Agency, this agency may request data from another country in several ways. How information is exchanged internationally will depend on the treaties that a country may have signed, including bilateral and multilateral treaties against double taxation, which include clauses addressing the exchange of information, or what is even more effective,

bilateral and multilateral mutual administrative assistance treaties, especially those that deal with the exchange of information.

5.2.2.1. Treaties to avoid double international taxation, with an information exchange clause

Broad bilateral or multilateral treaties on avoiding double taxation are frequently based on the OECD Model Treaty. Since this Model's initial version, which dates from 1963, a standard clause on the exchange of tax information has been included in Article 26. This article, along with the Model itself, has undergone successive modifications that have broadened the scope and purpose of the exchange of information.

The current version of Article 26 of the OECD Model states:

1. The competent authorities of the Contracting States shall exchange information necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by this Convention in so far as the taxation hereunder is not contrary to the Convention. The exchange of information is not restricted by Articles 1 and 2. Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by this Convention. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.
2. In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation:
 - a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;
 - b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;
 - c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information of which the disclosure would be contrary to public policy (public order).

It should be noted that from the analysis of Article 26 of the OECD Model and the Respective Comments, it turns out that the application of a clause of this nature is merely a partial solution to the exchange of information

needs that companies may have, as a result of the different limitations that are established in facilitating that exchange.

- Following the modifications introduced in the year 2000, the questions posed may be related to other taxes not discussed in the agreements (which always concern income tax and on occasion property tax). Any commitment by the receiving state to give information on other taxes was excluded.
- Furthermore, the reach of information exchange may be limited as described in the Comments (Paragraph 11), insofar as a state may deny the requested information if the said state did not have full assurance that the other agency would treat the information received under the same confidentiality standards demanded by the state's own legislation.
- With regard to the extent of information that may be subject to exchange, it shall be limited to the minimum legal and material possibilities presented by any of the contracting states (de jure and de facto reciprocity). In accordance with the described limitations, none of the states will be obligated to take administrative measures that go against their legislation or administrative practice, or to go above and beyond what the said legislation prescribes or what normally constitutes the said administrative practice. At the same time, an effort is made to determine what parameters establish the scope of the state's obligations, by referring to not only the state's own legislative and material limitations, which would seem logical, but also the limitations under identical circumstances within the state making the request. In this fashion, the information that a state is obliged to grant to the other contracting state, by virtue of Article 26 of the OECD Model, shall be limited to the least of all possibilities from a legislative and material standpoint of all of the states involved in the exchange of information. This fact is recognized in Paragraph 18 of the said article's comments, which states that if the structure of the two contracting states' information instruments are very different, the provisions of Sections a and b of Paragraph 2 of the Model's Article 26 would severely limit and perhaps eliminate altogether any exchange of information.
- Finally, there will be no obligation to provide information that reveals secrets of a commercial, business, industrial, mercantile, or professional nature, commercial procedures, or information that may upset the public order, such that special domestic laws will prevail, remov-

ing any possibility that the agreements may include provisions that restrict the reach of said domestic laws.

In accordance with the information contained in the Database on Basic Tax Information of the Inter-American Centre of Tax Administrations (*Centro Interamericano de Administraciones Tributarias* or CIAT), a total of 137 agreements for avoiding international double taxation were in force as of 31 December 2002, with the participation of CIAT member states from Latin America and the Caribbean.¹⁷

Of the total 27 CIAT member states of Latin America and the Caribbean, 18 are signatories to these types of agreement.

Of the 137 current agreements, three of them are multilateral: the Andean Pact agreement, the CARICOM agreement and the Kingdom of the Netherlands agreement. The CIAT countries that take part in the multilateral Andean Pact agreement are: Bolivia, Colombia, Ecuador, Peru and Venezuela; in the CARICOM agreement: Barbados, Jamaica and Trinidad and Tobago; and in the Kingdom of the Netherlands agreement: the Netherlands Antilles and Aruba.

Of the 134 bilateral agreements in force, 125 have been signed by countries outside of the region and the following countries of Latin America and the Caribbean take part in them: the Netherlands Antilles in 1, Argentina in 15, Barbados in 8, Bolivia in 5, Brazil in 22, Chile in 1, Cuba in 1, Ecuador in 7, Jamaica in 11, Mexico in 24, Peru in 1, the Dominican Republic in 1, Suriname in 1, Trinidad and Tobago in 11, Uruguay in 2 and Venezuela in 14.

The remaining nine bilateral agreements in force have been signed by CIAT member states from Latin America and the Caribbean: Argentina–Bolivia, Argentina–Brazil, Argentina–Chile, Barbados–Cuba, Barbados–Venezuela, Brazil–Ecuador, Chile–Mexico, Ecuador–Mexico and Trinidad and Tobago–Venezuela.

With regard to the exchange of information in these 134 bilateral agreements, five contain no clauses that deal with this topic: Argentina–

17. Argentina, Aruba, Barbados, Bermuda, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cuba, the Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Jamaica, Mexico, the Netherlands Antilles, Nicaragua, Panama, Paraguay, Peru, Suriname, Trinidad and Tobago, Uruguay and Venezuela.

Switzerland, Ecuador–Switzerland, Jamaica–Switzerland, Trinidad and Tobago–Switzerland and Venezuela–Switzerland. The remaining agreements were based on different versions of the clause from the OECD Model, with the exception of two that adopted the Andean Pact Model: Argentina–Bolivia and Argentina–Chile.

A large variety of diverse solutions is in evidence in the agreements based on the different versions of the OECD Model. With regard to the limitations in the exchange of information in the respective clauses, it should be noted that:

- nearly all of them establish that the exchange of information and the use of exchanged information may only involve those taxes covered by the agreement;
- in many cases, the purpose of the exchange is limited to the minimum necessary for the application of the provisions of the agreement;
- the vast majority of the agreements maintain the reciprocity requirement, both de facto and de jure.

5.2.2.2. The specific treaties on exchange of information and mutual assistance

The limitations mentioned above may indicate a need to create bilateral or multilateral treaties that deal specifically with the exchange of tax information. They may even have a broader purpose than the mere exchange of information, establishing other mechanisms for reciprocal administrative assistance for the control and execution of tax obligations.

When the goal is to combat tax evasion and avoidance, the exchange agreed upon through a clause from double taxation agreements does not seem to be the most suitable means for satisfying the tax agencies' informational needs, considering the increase in magnitude and complexity of international economic relations as a result of globalization. The availability of information from foreign tax agencies becomes indispensable for effective control of tax obligations.

Obviously, the above paragraph does not mean that double taxation agreements should not include exchange of information clauses. They will always be necessary to ensure the proper application of these agreements and if there is no better solution, such as a specific international administrative assistance agreement, these clauses could promote the exchange of information to some degree.

In summary, it would seem advisable to conclude agreements that deal specifically with the exchange of information when developing instruments to combat tax evasion and avoidance as a more effective and operative way, rather than merely inserting a clause dealing with this subject into a double taxation agreement, for the following reasons:

- *The process of globalization* is creating an ever-growing need for tax authorities to obtain information from outside their borders for effective control of tax obligations.
- *The taxes covered* by the double taxation agreements are income taxes or income and property taxes, that is, those which essentially form the basis of international double taxation. Furthermore, with very few exceptions that will be added to the new edition of Article 26 of the Model beginning in the year 2000, the exchange of information as a result of these agreements is restricted to these types of tax. However, large-scale tax fraud has been verified as occurring in the collection of indirect taxes, particularly in value added taxes and other indirect taxes subject to “border tax adjustment”, through export operations and/or false credits that result in wrongful collection of supposed balances in favour of the exporters.
- *The goals* of avoiding double taxation and establishing the exchange of information with other countries to combat tax evasion and avoidance are different, and it may be in a specific country’s interest to conclude an agreement that deals with one or the other but not both. Thus, in the case of Germany for example, which is the OECD country with the greatest number of agreements with CIAT member states from Latin America and the Caribbean, it could be interpreted that Germany is only interested in avoiding double taxation, as the exchange of information clause incorporated into all of its agreements is the “limited exchange clause”, that is, exclusively for the application of the agreement’s provisions. On the other hand, in the case of the United States, it would seem that priority is given to agreements for the exchange of information, at least as regards the CIAT member states from Latin America and the Caribbean, as there are nine agreements on this subject with these countries and only five on double taxation.
- *The differences* in legislative terms, administrative practices and material possibilities of exchanging information among the contracting parties, when establishing a type of mutual assistance for combating tax evasion and avoidance, are difficult to resolve through a sim-

ple clause, especially when there are marked differences in the degree of development between the contracting countries. The criterion of material and legal reciprocity, especially legal reciprocity, traditionally spelled out in double taxation agreements, would seem to be an inadequate solution and therefore not advisable for codifying the exchange of information, especially when the contracting parties have a very wide difference in their respective state of development, which is also reflected at the level of their tax agencies.

- The tax agents who are in the best position to contemplate needs, possibilities and the necessary formalities for the exchange of information with other countries are those whose duties include the management of tax collection, that is, the tax administrators. The negotiation and formulation of agreements to avoid international double taxation is a task which is in many countries assigned to government workers outside the tax agency, whereas in other countries participation by tax agency workers is merely peripheral or for simple application of those agreements. Since the subject at hand is the exchange of information to combat tax evasion and avoidance, *extensive participation by tax administrators* would be essential to determining the scope of the agreement, in particular to identify and propose the mechanisms and formalities that would result in operative effectiveness.

The advisability of concluding agreements dealing specifically with mutual assistance may be considered to be widely recognized insofar as there are still countries with a broad network of double taxation agreements amongst themselves, who have furthermore drafted and signed other agreements, also amongst themselves or with the participation of some other countries, dealing specifically with the exchange of information and other forms of mutual assistance, such as:

- Directive 1977/799 EEC, known as the Directive on Mutual Assistance, which established the obligation to assist other Member States of the European Union (known then as the European Economic Community). The purpose of the Mutual Assistance Directive is to strengthen cooperation among the tax authorities of EU Member States in order to combat tax fraud and the flight of tax moneys.
- The Multilateral Agreement for Mutual Administrative Assistance of the Council of Europe and the Organisation for Economic Co-operation and Development (OECD), concluded in 1988 and in force today. This agreement contains 32 articles and studies a broad range of

methods of administrative cooperation for the determination and collection of taxes, from the exchange of information to the execution of collection activities abroad, with the specific intent of combating tax evasion and avoidance.

- The Nordic Agreement on Mutual Assistance in Tax Matters, derived from the Treaty signed in 1972, which inspired the Multilateral Agreement of the Council of Europe and the OECD. The new version of the Nordic Agreement, which accompanies the terms of the Multilateral Agreement mentioned earlier, has been in force since 1991.

The topic of information exchange is given priority treatment in the CIAT, insofar as this exchange is recognized as the most direct method of assistance among tax agencies, and it is an essential instrument for the effectiveness of these agencies, especially for enforcing tax obligations.

The CIAT is an institution whose primary goal is to promote all types of international cooperation among tax agencies and promoting the exchange of information is one of the initiatives described in its Statutes and Strategic Plan. To this end, the CIAT created an International Taxation Working Group, and one of its aims is to promote the exchange of tax collection information, for which the following activities were developed:

- create a CIAT Model Agreement for the Exchange of Information, which was completed. The said Model Agreement was approved by the 33rd Annual General Meeting, held in El Salvador in 1999;
- create the Model's explanatory notes, which were also concluded and approved by the 35th Annual General Meeting, held in Chile in 2001;
- establish strategies and manuals for its use;
- determine the organizational needs for carrying out exchange of information activities;
- identify and programme mechanisms for technical support and training to aid in developing the exchange of tax information.

The aim of these tasks is to create a viable process for the drafting and application of agreements for the exchange of information, considered to be of vital importance in combating tax evasion, and which agreements nevertheless have not been used to the degree considered desirable among the CIAT member states, especially in Latin America. To that effect, the actions of the Working Group aim to establish parameters that go beyond the mere existence of a Model Agreement, striving to provide support and solutions for effective implementation and application by tax agencies.

The experience of the vast majority of CIAT member states from Latin America and the Caribbean is not very extensive in the area of specific agreements on the exchange of information.

There are a scant ten agreements of this type, nine signed with the United States and one with Canada.

5.2.3. Ways of exchange of information

5.2.3.1. Exchange of information upon request

If an officer of a Tax Administration has instituted an audit or investigation into cross-border income positions, and the national competences produce information that is insufficient for the correct levying of taxes, a request for information from abroad may resolve his problems. Calling upon another state is permitted only when the state's own instruments to obtain information have been exhausted. In international context requesting information from a foreign country is considered supplementary to national activities. This rule does not have to be observed if any investigation that is restricted to the national border would endanger the levying of taxes. For example, when a national investigation would enable a taxpayer to take measures for preventing tax assessments being imposed on him. In such cases, states can contact each other directly, without first having to use all available national instruments to obtain information. States will want to do so in cases of fraud. Before any request for information can be granted, it must meet the following requirements. In any case, the request must state for whom information is requested, what information is requested, for the purpose of which type of tax information is requested, and for what purpose the information will be used. *Mutatis mutandis*, these requirements equally apply to requests for information to a foreign country. The "competent authority" will test both incoming and outgoing requests against these criteria. The possibility has been created to initiate an investigation/audit for obtaining and delivering information requested by a foreign competent authority.

For the purpose of the legal protection of citizens, in some countries the actual provision of information is coupled with notifying the interested party. This interested party is the person from whom the information is obtained. For such notification procedures legal action is admissible.

5.2.3.2. Automatic exchange of information

Automatic exchange of information entails the periodic supply of information on specific categories of income of persons, which was agreed upon by states in advance. Such agreements can be concluded through separate arrangements that have to be published before they come into effect. An advantage of publicizing such arrangements is that on any exchange of information no individual notification has to be issued.

Another important advantage of automatically exchanging information is that it provides information on hitherto unknown taxpayers or sources of income without any special request. The information is exchanged directly between centrally updated databases. The idea is to transfer information digitally as much as possible.

5.2.3.3. Spontaneous exchange of information

In judging a tax return or carrying out an audit, an officer of a Tax Administration may come across data that could be important to the levying of taxes in another country. On the basis of these data he may suspect that in that country exemptions, refunds or freedom of tax are granted. In such cases, this information can be passed on spontaneously to that country without first having received a request from it. Just as the entire international traffic of information, spontaneously providing information is based upon reciprocity. The principle of reciprocity entails that only those data are provided that the other country conversely is also permitted to provide. A major factor in the spontaneous exchange of information is the quantity of the data (the so-called “factual reciprocity”).

There are five situations in which information could be provided spontaneously:

- (1) if a Member State suspects that in the other state an abnormal exemption or abatement of taxes (tax credit) has been granted;
- (2) if a taxpayer has been granted an exemption or an abatement that would cause taxes in the other country to be levied or increased;
- (3) if transactions between one state and another are conducted through one or more different countries creating tax savings in one or both states;
- (4) if the suspicion arises that profits are artificially shifted within a group of companies;

- (5) if, in one state, on the basis of information received from another state, data emerges that may be of importance to the levying of taxes in the other state.

5.2.3.4. Assistance in person

Assistance in person means that an officer of a Tax Administration of one country, after a request, can be permitted to be present in an audit or investigation in another country. This possibility is particularly important for complex cases, in which the “foreign” tax officer possesses knowledge that makes it desirable for him to be present in the audit or investigation, allowing this to be conducted more rapidly and efficiently. With regard to this form of assistance additional arrangements can be made between states.

Generally, any request for a tax officer being present in the territory of another Member State is permitted in special cases only. Examples:

- indications of cross-border irregularities, or fraud of significant magnitude;
- terms are threatened to be exceeded and the presence of the tax officers can speed up the case;
- complex cases.

5.2.3.5. Books and accounts kept abroad

When books and accounts of a company are kept in another state, this can be a reason for a tax officer to be present for an audit in that state. Possibly the company requests the presence of a tax officer of the requesting state, because it is difficult to send documents and employees to the requesting state for an audit to be carried out there. This would not be a case of “assistance in person” because the presence of the civil servants is not based upon a formal request for information. The Tax Administration will always be informed of the presence of a foreign tax officer.

5.2.4. Simultaneous audits

5.2.4.1. Concept of simultaneous audits

Carrying out different audits at the same time is the latest form of international cooperation. A simultaneous audit is an audit in which several countries are auditing an international corporation or group of (non-affiliated) companies at the same moment in time, with exchange of collected information. This approach is introduced in the Convention of Mutual Assistance. Also, this Convention stipulates the possibility for examinations of books, records and other documents in another signatory country “to have representatives of the competent authority of the requesting State be present in the part of the examination of books, records and other documents in the requested State that is important to that State”.

5.2.4.2. Position within the context of international cooperation

International cooperation is possible in various ways and in various degrees:

- national audits with exchange of information with a foreign country, either as a part of a bilateral relationship, or spontaneously;
- coordinated bilateral cooperation;
- multilateral cooperations (including multilateral auditing).

Multilateral auditing is the most intensive form of international cooperation because of the far-reaching involvement of several countries. Multilateral auditing often presents the most opportunities, but it must be deployed with due consideration. On the one hand, such a careful assessment must be made in view of the national interests with regard to the nature of the object of the multilateral audits, the fiscal importance, the expected additional tax revenue from the multilateral approach and the related costs. On the other hand, such an assessment is important in view of the intercourse between states. The latter factor refers to the so-called principle of proportionality entailing that the efforts that treaty states can reasonably expect from each other. The efforts must be normal or reasonable and must be made as part of more or less usual efforts made by the requested treaty state.

5.2.4.3. Form and contents of a multilateral audit

A multilateral audit can be carried out in various forms. These forms vary in efficiency and effectiveness; also laws and regulations of countries can vary:

- simultaneous audits by tax officers in their own territory. This is the most common way. Tax officers from the participating country only meet in starting and closing meetings and can mail in between;
- audits with “assistance in person”, in which tax officers of a foreign country are present in the territory of another state. Details depend upon the international arrangement and the national laws and regulations;
- joint audits, in which tax officers of one country participate in an audit, conducted in the territory of another state, using local auditing competences. This goes beyond “being present”. Possibilities and details depend upon local legislation and the willingness of the competent authority of the host country;
- audits in the territory of another state, in which tax auditors are permitted to use their own national auditing competences.

Multilateral audits also vary with regard to their contents:

- audits that address only internationally operating companies;
- audits of a group of internationally operating companies that are not affiliated and that have a customer-supplier relationship;
- audits for combating fiscal “constructions”;
- audits aimed at VAT carousel fraud.

5.2.4.4. Reciprocity in a multilateral audit

Testing the principle of reciprocity is an item in considering each request for information, and thus each request to a multilateral audit.

The principle of reciprocity entails that the requested information would also be provided by that requesting state. The principle implies that both international arrangements and regulations, and also the formal competences in another country, are important. Thus, it may occur that international treaties and regulations between certain countries offer possibilities for jointly conducting an audit, but that national legislation of one or more of these countries prohibits the exchange of information. For example, if a country has not legislated certain auditing competences that exist in another country, then the requirement of reciprocity is not met.

5.2.4.5. Stages in multilateral audits

The execution of a multilateral audit consists of several stages:

- the selection process;
- the planning process;
- the execution of the auditing plan;
- forming a judgement;
- reporting.

The selection process

In view of the fact that a multilateral audit is an expensive form of auditing, with international implications, an application procedure has been created that enables careful weighing of the interests.

The planning process

During the planning stage a starting conference will be held. This starting conference is a first-orienting meeting, organized by the requesting party, which is attended by all participating parties.

The objectives of this conference are:

- making one another's acquaintance;
- exchanging information on the organization of the Tax Administrations of the participating countries;
- providing information on the company to be audited;
- preparing a project plan and an audit programme.

In the orientation stage the exchanged information is used to chart the corporation or group of companies to be audited, to substantiate the request and to clarify the audit programme.

Execution of the audit programme

During the execution of an audit the actual exchange of information takes place. It is possible that each country operates in its own territory. When the audit is carried out in the presence of foreign tax officers the exchange will be frequent. The tax auditor will have to record accurately which data have been provided to the foreign tax officer.

Forming a judgement

Depending upon the nature and contents of the audit, it can be decided in the interim to reconcile the available data. The same observations apply to

this procedure as described in the previous paragraph on providing information. In view of the notification to the interested party, the information provided must be recorded carefully. During the concluding stage, the entirety of the information gathered in the various countries is reconciled and aligned. In addition, any adjustments in the various countries are discussed and compared.

Reporting

The tax auditors of the participating countries report separately to the taxpayer. These reports only state the data and the adjustments in as far as they are important to the national levying of taxes.

5.2.5. Risk analysis

The risk analysis is essential to prepare a proposition for a multilateral audit. The fiscal risks are determined by the tax legislation and the nature of the company to be audited. Before a risk can be designated as relevant, the risk must be detected and a risk analysis must be made. These are separate processes. Risk analysis refers to identifying and describing any risks. Risk detection is the process of discovering whether the risk is present. Within the context of a multilateral audit this separation cannot be maintained properly. A risk is first detected, and only then described.

5.2.6. Risk profiles

In the following paragraphs some risk profiles are described, specifying risk, source, detection and an explanation. Some risks can occur in various types of tax. In the explanations the overlapping areas of the risks with regard to the different types of tax should be described.

5.2.6.1. Risk profiles: transfer pricing

In 1995, an OECD report was reviewed and published under the title “Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations”. In this report the instrument of “simultaneous examinations of books and records” is extensively explained. Three types of risk are distinguished in transfer pricing:

- cost allocation;

- allocation of income;
- restructuring intangible assets.

The first two types of risk do not require any explanation, whereas in the third class of risk all other problems are classified. In recent years, multinationals all over the world are being restructured. They try to make these endeavours a success by using transfer prices. In many cases they seek to contact the Tax Administrations involved.

5.2.6.2. Risk profiles: value added tax

The risk: carousel fraud

Source: Industry-targeted investigation in industries susceptible to fraud.
Explanation: carousel fraud of VAT is frequently committed in trading computer chips and other electronic equipment. Small components represent large amounts of money. Carousel fraud may have various shapes and forms, the basic pattern, though, involves at least three companies and works as follows:

A company in Country A acquires goods from Country B through an intra-Community transaction. Next, the goods are sold with VAT to another company. The VAT thus collected by the suppliers, however, is never paid to the tax authorities, but will be reclaimed or deducted as prepaid VAT by the buyer. The latter, in his turn, sells the goods again to the first supplier abroad through an intra-Community transaction. The challenge now is to detect companies that invoice VAT, but do not pay it. In this scheme also so-called shell companies are used, which accrue large tax liabilities and then go bankrupt. Speedily exchanging information and taking action are key success factors in tackling this type of fraud, which is also committed with excise duties.

The risk: wrongfully applying the zero rate in export transactions

Source: VAT auditing.

Explanation: An OECD task force is engaged with exchanging VAT data. The exchange of data does not stop at the borders of the European Union. Export is at a zero VAT rate. On the basis of books, records and other documents the exporting company must prove that he has applied the zero rate correctly. The risk is that goods do not really leave the country. The risk increases if the buyer collects the goods from the selling company.

5.2.7. Knowledge of tax auditing processes

A fair and equitable taxation is only possible if a Tax Administration has all relevant data of a taxpayer. To internationally operating companies national borders no longer impede or even hamper business activities. However, Tax Administrations are still confronted with the boundaries of fiscal sovereignty. As a consequence, Tax Administrations intensify their exchange of information and increasingly cooperate in conducting tax audits and other fiscal investigations.

With respect to the levying and collection of taxes, each Tax Administration has developed its own powers (“competences”) and instruments. Often, the auditing process of countries differs because history and culture have had their unmistakable impact on taxation. In order to get cooperation properly going, it is important that tax auditors are well informed of the possibilities for tax auditing, legal powers and competences, and the major characteristics of tax auditing in other countries.

Good practice in the Netherlands:

The need for information has urged the Tax Administration of the Netherlands to compile and publish a series of studies of tax auditing practices in various countries. These studies consist of a description of the tax auditing process and all things related in a country. They describe (or will describe) tax auditing in the Member States of the European Union, the candidate Member States, and a number of important trading partners of the countries of the European Union, such as the United States, Canada and Japan.

Using a standardized set-up, the studies provide, after a brief overview of the (fiscal) history of a country, a description of its tax system, the guidelines for tax auditing, tax auditing policy, the tax auditing process, and the international aspect of tax auditing. Not only do these studies enhance international cooperation, they offer opportunities to learn from the way Tax Administrations in other countries operate.

5.3. International transactions

5.3.1. Introduction

Companies increasingly operate across the borders of the country in which their head offices are established. As a consequence, Tax Administrations are confronted with new challenges and issues in the area of examination. At the core of these problems lies the assessment whether transactions between parts of internationally operating groups of companies are commercially justified (“transfer pricing”). A consequence of non-commercial pricing may be that the results of parts of the group are being manipulated (and recognize profits in countries with a favourable fiscal regime), and that countries with less favourable laws and regulations collect less tax revenue than intended. Recognizing this problem area, the OECD published in 1979 its “Transfer Pricing Guidelines for Multi-National Enterprises”. Since this first edition these guidelines have been amended and extended a few times, most recently in 1999.¹⁸

The problem area of transfer pricing includes an important microeconomic component. This component has two major aspects. Firstly, (micro)economic knowledge is important in determining the level of prices in internal cross-border transactions. This knowledge should extend to the composition and structure of the entire group of companies, the competences of the various elements of the group, and the definitions that are used with regard to prices, transactions and market. Are the reconciliations made between the transfer pricing system and the budgeting and marketing systems, between the transfer pricing system and the accounting and fiscal system? Are all risks really reflected in the prices? To be able to answer questions of this type a Tax Administration needs employees who are highly trained and educated. These employees not only should be able to tackle complex accounting and national fiscal problems, they must also have a sound knowledge of (micro)economics, of the accounting organization of large companies, and of international law.

The second aspect is about the group of companies as such. In general, the transfer prices imposed by the top of the group to be used in frequent transactions will constitute an infringement of the current rules with regard to costing, budgeting and marketing. This will have consequences for the performance of parts of the company. Thus, the group will want to adjust

18. OECD, *Guidelines for Conducting Advance Pricing Agreements under Mutual Agreement Procedure*, 1999.

the evaluation criteria to the extraordinary circumstances, so as to be able to measure the progress towards the company objectives and to control the business processes within the group.

The following elements may be part of a system of transfer pricing:

- the various parts involved within the group or the company;
- description of competences of various parts of the groups;
- definitions of costs, transactions and markets;
- conditions, terms with regard to payments and operational currency;
- records on contracts, prescriptions, as well as general documentation;
- structure and functioning of the transfer pricing system, internal policies, and any internally used manual;
- functional analysis;
- survey of comparable variables together with ratios;
- arrangements for settling disputes;
- structure for consultation;
- accounting support;
- reconciliation with the budgeting and marketing systems, as well as with the accounting and fiscal systems.

5.3.2. Two concepts: affiliation and the principle of “arm’s length”

Two concepts have a crucial role in transfer pricing, notably the existence of affiliation between companies, and the “arm’s length” principle. The issue of transfer pricing is inseparable from the question whether or not transactions were between affiliated companies. If parties are not affiliated, their mutual dealings are between third parties. These dealings are, in principle, always of a commercial and business-like nature. Under Article 9 of the OECD Model Treaty a state of affiliation must be presumed if:

- a company, directly or indirectly participates in the management, the supervision, or the capital of a company in the other state; or
- any one person, directly or indirectly, participates in the management, the supervision, or the capital of a company in one of the states as well as in a company in the other state.

The term “person” refers to both individuals and legal persons.

The OECD Model Treaty does not provide further guidelines on any minimum requirements with respect to the holding (participation) in the cap-

ital. For concepts that are not defined in the Treaty, its Article 3, Paragraph 2 refers to the relevant national legislation, unless the context demands differently. In the Netherlands, affiliation is presumed to be the case if the holding exceeds 33.3% of the equity capital.

The “arm’s length” principle is the international standard to which OECD Member countries are bound in judging transfer prices for taxation purposes. In Article 9 of the OECD Model Treaty the principle is described as: “where conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly”. Observing the “arm’s length” principle, though, does not result in an exactly calculable price, but to a range within which that commercial price would be.

5.3.3. Transfer pricing

An investigation into transfer pricing should be broken down into a number of different steps. The first step consists of making a survey of the transfer pricing issue as it may occur in the company to be investigated. This should include an analysis of the composition of the group of companies as a whole, and of the tax regimes with which the group is confronted worldwide. In the next step, it should be established which parts of the group or of the individual company would be pre-eminently suitable for transfer pricing within the group. Also, it should be carefully investigated which shifts have been made in the activities and the composition of the group. If it can be established that transfer pricing is used within the group, the fiscal implications should be calculated on the basis of the “arm’s length” principle. The OECD has defined a number of methods for this.

5.3.3.1. Survey

Without any affiliation it does not make sense to investigate any transfer pricing. The first step is, therefore, to establish which directly or indirectly affiliated parties there are. Annual reports and accounts of the parent company are useful in bringing to light any affiliated companies, but also an interview with the managing board of the company (or with a representa-

tive appointed by it), press reports, information for trade and professional periodicals, brochures by the group itself, or reports and minutes of meetings can be equally instructive. When the group of companies has thus been charted, insight must be obtained into its worldwide fiscal position. The objective is to analyse where within the group transfer pricing would be beneficial.

The fiscal position depends upon many matters. Relevant aspects are the existence of structural (fiscal) losses, or heavily fluctuating results that structurally tend to zero; actual or immanent conflicts with a foreign Tax Administration; any opportunities for evading taxes at source on dividends through paying dividends under a different title; any differences in tax rates between entities concerned; any discrepancies between tax regimes and cultures in countries in which affiliated parties are established.

To the extent that differences in tax rates for affiliated parties within a group of companies become larger, it will become more attractive to the group to shift group profits to the country with the lower rate. It may also be the case, though, that one of the parties is a tax-exempt entity, or has large losses that can be carried forward. Thus, transfer pricing issues may also very well have an impact within the national borders.

It may be important to the tax regime and the culture of the country of an affiliated party to establish the underlying reasons for a certain transaction or, to put it differently, which tax regimes bear inherent risks, and what the consequences are of the dominant culture. For example, if in a country a certain type of fee, reimbursement or expense is non-deductible, the result may be that in the companies in that country all sorts of concealment or covered-up transactions are arranged. If the culture of a country is strongly hierarchical or centralistic, it may occur that multinational companies in that country fix transfer prices, the acceptability of which cannot be assessed by (the Tax Administration of) the subsidiaries in the Tax Administration's own country.

If it becomes clear from this first survey of the group of companies that there are opportunities for the use of transfer pricing, a more detailed analysis of the business activities should determine the direction of further investigations. The objective here is to obtain insight into the possibilities for manipulating the taxable amount, taking into consideration the nature and complexity of the operations. In this analysis a distinction should be made between occasional and structural transactions. In the case of occasional transactions the nature, size and independence of activities and/or

functions should be established. This part of the investigation should include, and indeed focus on, transfers from unaffiliated to affiliated elements in relation with and/or accompanied by changes in functions, risks and results with regard to taxation. Additional reasons for opening the debate with the group on any transfer pricing it uses result from the pre-affiliation results of the part of the group concerned. Thus, these results constitute an external standard.

Occasional transactions include the purchase and/or sale of participating interests, changes in the group structure, and changes in the nature, number and/or structure of affiliated parties. Changes in the group structure to be investigated are those of the nature, set-up and complexity. The changes are in respect of legal and material aspects: it is essential to determine whether, and if so to what extent, the management of the group is able to intervene.

In more frequent transactions the relationship with (micro)economic principles is much more pronounced. Relevant aspects that should be covered by the investigations include, for example, the profit responsibility (profit centre) of part of the group, the results of financial analyses, the results of analyses of the quality of the profits, and the results of investigations into transfer pricing in similar entities.

Signals concerning both types of transaction may come from the Customs Administration (for instance from its investigations of valuations, import levies and export subsidies). Other sources include reports in the media, signals from interviews with representatives of the group of companies, minutes of meetings, and studies commissioned by the group or by a foreign part of the group.

After this stock-taking process it should have become clear whether the group indeed uses transfer pricing, and whether that use results in tax revenue being missed. The outcome is decisive for whether or not to institute a further investigation, now partly into matters which relate to the accounting system. Such investigations into this problem area have one characteristic in common: they are labour intensive, whereas the outcomes are uncertain. In order to control the time that will be spent, it may be decided to divide the investigation into an exploratory investigation into transfer pricing, which may or may not be followed by a more thorough investigation.

5.3.3.2. Exploratory investigation

The exploratory investigation as a supplement to the first analysis should provide insight into the nature and extent of the fiscal risk. The investigation concentrates on the environment within which the part of the group concerned operates. The exploratory investigation is divided into ten items:

- (1) making an analysis of the role, status and fiscal position of affiliated parties; obtaining insight into the group structure (worldwide), activities and results at group level (initial analysis of functions and risks);
 - (2) examining the documentation (of the group) with regard to the transfer pricing system;
 - (3) making a survey of the transaction flows with affiliated parties;
 - (4) examining the main features of the accounting organization and internal control measures with respect to transfer pricing transactions;
 - (5) examining the (OECD) methods used, as well as the transfer pricing system;
 - (6) examining the budgeting methods and the budgeting system;
 - (7) examining the standards as they have been formulated and are applied;
 - (8) examining the consultation procedures and minutes of (management) meetings, meetings of the Managing Board, the Board of Directors, etc.
 - (9) making a preliminary financial analysis;
 - (10) identifying audit objects, and preparing an auditing programme.
- (1) *Making an analysis of the role, status and fiscal position of affiliated parties; obtaining insight into the group structure (worldwide), activities, and results at group level (initial analysis of functions and risks)*

At the start of the exploratory investigation it had been established as a fact that affiliation exists. Next, it should be investigated which role the affiliated parties concerned play. The principal features, relevant functions and risks of those parties should be charted. The term “functions” refers to economic functions such as purchasing, production, sales, finance, etc.

(2) Examining the documentation (of the group) with regard to the transfer pricing system

The OECD report of 1999 on transfer pricing pays much attention to the contents and extent of the documentation that may be expected. This documentation should provide insight into the transfer pricing systems used within the group of companies, making such documentation a crucial facet in the exploratory investigation.

(3) Making a survey of the transaction flows with affiliated parties

By using internal annual accounts, questionnaires and company interviews, insight is gained into the transaction flows between affiliated parties. It is important to recognize that diverse flows may be important with regard to the transfer pricing issue, such as the principal flows for purchase and the sale of goods, flows of services, and flows with regard to making available rights, knowledge, data, patents, etc. These last flows usually do not entail physical or visible flows because they are in respect of intangible matters that have not been capitalized, and thus are not visible from the financial accounting system.

(4) Examining the main features of the accounting organization and internal control measures with respect to transfer pricing transactions

The accounting organization and the internal control system will, in normal circumstances, not be the subject of a tax audit. Yet, some knowledge of this subject is required in order to obtain insight into the valuation and the processing of items in the annual accounts and in the tax return. Depending upon the size of the group of companies, questions should be asked about guidelines, policies and procedures with regard to the pricing in transactions between affiliated companies. Where those documents are indeed available, the question should be answered whether these guidelines, policies and procedures are indeed followed and applied.

(5) Examining the (OECD) methods used, as well as the transfer pricing system

Insight should be obtained into the internal prices used by the company. This information may have been acquired already through the documentation (see under (2)), or through the examination of the accounting organization and internal control system (see under (4)). Supplementary interviews should make clear which method for internal pricing is used.

(6) *Examining the budgeting methods and the budgeting system*

Budgets and budgeting systems are intended to set a target for the next period for parts of (large) groups of companies and their responsible officials (standard for the way in which the business activities are to be conducted). The performance of the part of the group and the officer are directly related to this target. During the period covered by the budget, a company should continuously confront the reality with the budget. At the end of the period the accounts are settled, often quite literally in the form of bonuses.

Depending upon the degree in which budgets are detailed, they yield more or less information relevant to the transfer pricing investigation. However, the exploratory stage is not intended to include an investigation into the budget cycle of the group of companies (methods by which and moment at which budgets are set by the parts of the group concerned, or by the officers concerned). Internal annual accounts often report on the actual and budgeted figures for the year(s) concerned. These data show, amongst other things, budgeted purchases, sales, margins, expenses and profit. In addition, the annual accounts will provide the differences (variations) between reality and the budget. These data can contribute to the insight into the way in which internal (transfer) prices are arrived at, and into their fiscal acceptability.

(7) *Examining the standards as they have been formulated and are applied*

Obviously, the standard used in the transfer pricing investigation is the “arm’s length” principle. Affiliated parties are obliged to set their internal prices as companies would who are independent from each other and have commercial relationships in equal or objectively comparable circumstances. For the transfer pricing investigation standards can be distinguished into internal and external standards. Internal standards can be found within the group of companies; external standards in its environment.

Standards from within the group are, for example, the gross profit margin achieved in year t compared with the profit margin of year $t - 1$. Another example is the selling price for an affiliated customer compared to the selling price for an independent third party. It also should be investigated which ratios determine the primary compensation or incentives for employees. Bonuses should be linked to transaction flows which can be

controlled by employees. If transfer pricing is used, bonuses tend to coincide with volumes achieved, and not with profit margins.

The key advantage of using internal standards is that the standards can be found within the group itself, and thus they will be more readily accepted by the group than external standards. In other words, if internal standards are used, the group will have to explain why in affiliated relationships prices are used that differ from those in relationships “at arm’s length”. If internal standards are lacking, the investigators must fall back on external standards. Such external standards could include official quotations and gross profit margins of competitors. If there is any deviation of the external standard from the prices used internally for transactions with affiliated companies, the burden of proof for the correctness of the external standard often rests with the Tax Administration.

(8) Examining the consultation procedures and minutes of (management) meetings, meetings of the Managing Board, the Board of Directors, etc.

In this stage of the investigation it is recommended to examine the minutes of the existing governing bodies, such as the Managing Board, the Board of Directors, the General Meeting of Shareholders, the body representing the employees, etc. Within the group many other consultative structures may exist, for instance meetings on the marketing strategy. It is important to have a proper overview of existing forms and means of consultation.

(9) Making a preliminary financial analysis

By financial analysis is meant the analysis of financial data of (a part) of the group of companies. The essential element of the financial analysis is the analytical review, the economic analysis, and the interpretation of specially prepared series of figures and groups of ratios. The analytical review is one of the most important auditing instruments in a transfer pricing investigation. By using an analytical review, it is attempted to trace relationships and links, to follow any developments in the context and to draw conclusions. Thus, the review is mainly targeted at the transfer prices being used. The availability of data determines to a large degree what can be achieved in respect of the depth and the extent of the review.

The analytical review should be directed mainly at the disruption of any trends with regard to revenue, expenses and the resulting profit margins. If possible, each of these categories should be reviewed in detail. The outcomes of this part of the exploratory investigation determine to a large

degree whether or not a full transfer pricing investigation should be conducted. If no leads for further investigations are found in this stage, then this is where the exploratory investigation ends.

(10) *Identifying audit objects, and preparing an auditing programme*

This part of the investigation should be completed by selecting objects to be audited. In order to keep the consecutive thorough investigation under control, it is important to describe objects selected for an audit as specifically as possible, and to restrict them to products or services targeted separately. In general, a selected product or service can best be examined in each part of the group separately, and should thus not immediately be investigated in all companies of the entire group. A truly general and universal rule cannot be given, because each transfer pricing situation is different. The exploratory investigation is completed by drawing conclusions on whether or not the issue of transfer pricing exists in the group concerned. If it does, the direction of the thorough investigation should have been established.

5.3.3.3. The transfer pricing investigation

If an exploratory investigation has been carried out, it is certain that transactions between affiliated parties take place and a reasonable conjecture exists with regard to the nature of those transactions. Before a start can be made with investigating the internal prices used, two further analyses should be made: the functional analysis and the financial analysis. Next, the “arm’s length” prices can be approximated by applying the methods formulated by the OECD.

The functional analysis

The reward of a transaction usually reflects the functions fulfilled by (independent) parties, taking into account the use that is made of assets and the risks that are run. The purpose of the functional analysis is to chart functions and risks, including the use that is made of assets, the costs and, particularly, the risks attached to the company activities and to the transactions. In the free market an increased risk will be compensated by a higher profit than expected. On the basis of the functional analysis an assessment can be made of the value added by a part of the group, a function, an activity or a risk run. It should be established which party bears which risks, and which functions this party fulfils. Next, the reward for the functions and risks identified should be compared with the reward that

would have been agreed upon between independent third parties in otherwise equal circumstances. In this comparison the structure and organization of the whole of the group should be taken into account, as well as the legal form of the company concerned.

The functional analysis can have various gradations and forms. The thoroughness and the degree of detail may vary. Moreover, a distinction can be made with respect to the level at which the analysis is made, i.e. at the level of the group, the local level, or the level of the business processes (function, design, risk).

In the OECD guidelines the concept of transaction has a key position. The starting point here is the use of a commercial price at the level of the transactions, preferably at the level of each individual transaction. Reality, though, is often more complicated, as many products are supplied in mutual dependency and can hardly be evaluated separately. Examples are mobile telephones in combination with a subscription; Barbie dolls and their assorted accessories; and passenger cars and their diverse models and features. Starting from the frequent case that prices are set for individual types of transaction, the following main classes of transactions can be distinguished:

- the transfer of (a part of) a company;
- the transfer of functions producing intangible assets (for instance research and development);
- the transfer of other functions, such as manufacturing, distribution, warranty, warehousing and quality control;
- the transfer of risks;
- the transfer and/or making available of business resources (tangible and intangible resources, including knowledge and personnel);
- the supply of raw materials, half-finished products, components and finished products;
- the supply of services as part of the primary process;
- supporting services;
- finance.

Within the group or part of the group functions are performed. In identifying these functions, the assets used should be known, such as plant and equipment, valuable intangible assets, as well as their characteristics, such as their age, market or fair value, and location. Within the business process the following functions are distinguished:

- purchasing inventory management (economic);
- production, and warehousing and transport;

- marketing, services, sales, and warranty and after sales services;
- research and development, and the management of intangible assets;
- treasury, budgeting, insurance and finance;
- management and administrative support.

When the activities and/or functions of (the part of) the group have been charted, their relative importance should be established. Here, it is important to assess what the influence (the part of) the group has on pricing, volumes and the allocation of costs, which risks are run and which costs are incurred, and which reward compensates these costs and risks. The principle to work from is that, in general, a higher risk is compensated by a higher profit expectation. In any case, companies should assume that they are able to bear risks to a reasonable extent. The following risks can be distinguished:

- efficiency and calculation risk;
- the risk with regard to the capacity utilization result;
- stock risk;
- price, bad debt and currency risk;
- development risk;
- liability risk;
- market risk;
- warranty risk;
- risk with regard to the physical environment.

The function that (a part of) the group performs, determines in part the extent and the allocation of the risks it runs. Intentionally allocating risks should thus be in accordance with the economic reality of transactions. This reality, or the actual behaviour of parties, is the best gauge with regard to the risk allocation. In consciously and rationally allocating risks it is also important that the party best equipped for it bears the risk.

In the functional analysis special attention should be paid to intangible assets. Examples are: trade names and brands, marketing value, corporate image, quality of organization and personnel, including the available know-how, software, databases, distribution channels, licences, patents, etc. The most important problem with respect to these assets is the fact that they often have not been registered separately in the books and records, although their functions are important and clearly add value.

The financial analysis

After the functional analysis has been completed, the existence and the completeness of the transactions with affiliated parties should be established. Not only the charging for products supplied, services performed and the parts of a business or intangible assets transferred should be investigated, but it should also be verified whether all charges made to a part of the group were in respect of real accomplishments. Here also, special attention should be paid to the transfer of intangible assets. In order to judge the pricing, also the risk run should be taken into account. In order to establish the existence and completeness of transactions, the methods described in Chapter 4 can be applied.

5.3.3.4. Determining commercial prices

The definition of a commercial price is based on Article 9 of the OECD Model Treaty. In its essence, the concept is about comparability, meaning that no differences may occur that materially influence the circumstance to be investigated, or that no accurate estimates can be made with which the differences can be eliminated. In other words, characteristics of transactions or parts of a group that may influence the conditions to commercial dealings should be comparable. The guidelines as included in the OECD report will be discussed briefly. The report identifies nine steps for arriving at commercial prices.

Step 1: Analysis of comparability

As was pointed out earlier, the commercial nature of transactions is assessed by comparing them with similar transactions between independent parties. A number of factors influence the comparability:

- the characteristics of goods or services;
- the relationships between functions as made clear by the functional analysis;
- contractual conditions;
- economic circumstances;
- corporate strategies (for instances, for achieving a certain market share).

Step 2: Recognizing and identifying transactions that have actually been concluded

Tax Administrations should not fail to take into account any transactions that actually have been concluded, nor should they confuse them with or substitute them by different transactions. There are two exceptions to the rule to start from the form of the transactions. The first is the principle of “substance over form”, in cases where the economic reality of the transaction does not match with the form. In those cases it is permitted to reclassify them according to their essence, their “substance”. The second exception is in respect of any agreements that can only have been made between affiliated parties, and that in their entirety are different from arrangements between independent third parties.

Step 3: Evaluation of transactions separately and combined

Preferably, clusters of transactions and even individual transactions should be broken down. However, as mentioned before, this may not always be possible.

Step 4: Applying an “arm’s length” range of prices

A recently implemented change of previous OECD Guidelines and reports has created the possibility to calculate the transfer prices within a certain range, as it would be more an exception than the rule that the calculations of transfer prices would arrive at one reliable value. Using a range is justified because many assumptions have to be made about the conditions in which companies conclude contracts. The process becomes even more complex as even independent companies do not act in one and the same way in equal circumstances.

Step 5: Using data from several years

By using figures from several years, occasional extremes can be eliminated. As a result, a better insight into facts, circumstances and developments occurs. In applying this technique, though, care should be taken to transfer back insights gained later.

Step 6: Losses

An independent company will shut down those activities that permanently make losses. If, however, in a part of a group of companies permanent losses are made, and the activities are not stopped, this will be a signal that

these activities entail a relevant function to the group. Continuing these activities or functions should be set off by an adequate compensation.

Step 7: Intentional set-offs

The concept of an intentional set-off refers to an exchange (set-offs or compensations) that affiliated companies deliberately include in the terms and conditions for group transactions. These set-offs may vary in size and complexity. The transaction does not produce profits or losses to either parties, and in fact does occur between independent parties. To be able to judge such a transaction, proper documentation is essential.

Step 8: Using valuations by the Customs Administration

Companies have opposite tendencies with regard to valuations by the Tax Administration and by the Customs Administration. For customs purposes they will seek to obtain a valuation as low as possible, whereas for determining the profit the cost of goods will be set as high as possible. The customs value is particularly important because it is fixed at the actual moment of transfer. Documentation and data are current at that time.

Step 9: Methods for transfer pricing

For the application of the “arm’s length” principle the OECD suggests, in principle, several methods. As such, a distinction can be made between traditional transaction methods, other methods and other approaches. To conclude, these methods will be discussed in the next few paragraphs.

5.3.3.5. The OECD Model Treaty and pricing according to the “arm’s length” principle

To be used as a tool for calculating transfer prices, the OECD has described some traditional methods; the “comparable uncontrolled price method” (CUP), the “resale price method” and the “cost-plus method”. These methods have precedence over the other methods, notably the “profit split method”, and the “transactional net margin method”. In addition to these calculation methods, the OECD describes two approaches that aim to prevent any conflicts with regard to transfer pricing. These are the “mutual agreement procedure” (MAP), and the “advanced pricing arrangement” (APA). Instituting a “simultaneous tax examination” (also referred to as multilateral tax audits) is an option to audit parts of the group of companies concurrently in several countries. The OECD has not yet

issued a positive opinion on the application of two other techniques: the “safe harbours” and the “arbitrage” techniques.

The OECD’s pointing out calculation methods may give rise to the unwarranted impression that transfer prices can be determined by using a simple “template”. However, in practice each of the methods that will be described below will have its own complications. These complications are related to, amongst other things, such aspects as comparability and allocating, quantifying and classifying costs. If only a relatively modest part of a group is established in the country of the Tax Administration concerned, it will be less simple to gather the information on the group it needs than when the group’s top management or the largest part of the group is established in the country.

Finally, in applying the various calculation methods, the impact should be taken into account which effect any subsidies, tax credits and restrictions to the deductibility of expenses may have upon the level of unit costs and profit margins to be realized.

The comparable uncontrolled price method

The comparable uncontrolled price method (CUP) compares the prices of products and services that are charged in affiliated companies with the prices that in comparable circumstances are charged for comparable products and services to independent parties. Any differences between those prices may signal non-commercial prices in affiliated relationships, and thus may necessitate a correction of these prices. For their comparability, transactions should be similar, products should be of the same type, quality, and quantity, and the transactions should have taken place at approximately the same time. Any differences in the circumstances should not be of such importance that they may influence the pricing more than marginally. In theory, this is the most reliable method for calculating transfer prices. In practice, though, finding comparable transactions between independent parties is one of the most important obstacles to applying this method.

The resale price method

In the resale price method, the selling price (of a product sold by an affiliated company) charged to an independent third party is decreased by the gross profit margin that an independent vendor would want to earn in order to cover his sales and other costs, and to enjoy an appropriate reward (profit). What remains after having deducted the gross profit margin can be

considered a commercial price for the transaction between affiliated companies of the group preceding the sale. This price may need to be adjusted for such expenditure as customs duties related to the purchase. This method is especially useful for transactions between parts of a group of companies that are charged with sales, marketing, or distribution activities.

The cost-plus method

Starting point for the cost-plus method is the costs incurred by the supplier of the product or service, to which a mark-up for profit is added (the “plus”). The cost, plus the mark-up, should be in proportion to the functions that are performed, the risks run, and the conditions in the market. This method is particularly useful with respect to the production of semi-finished products or finished products, in allocating (overhead) costs of the central office, and for supporting and supplementary functions.

As a calculation method the OECD clearly prefers the CUP method. If the part of the group mainly fulfils some special functions, the resale price method and the cost-plus method may be useful. In practice, combinations of the various methods are used. These combinations do not only consist of the traditional transaction methods, but may also include other methods.

Other methods 1: Profit split

If transactions are strongly interdependent, it may occur that they are impossible to assess separately from each other. The profit split method breaks down the total profit of the interrelated transactions on the basis of the functions performed and the risks run. To each of the transactions a part of the total profit is accrued, taking into account the market conditions. The advantage of this method is that it depends to a much lesser degree upon so-called comparable data of independent parties. Disadvantages relate to having to estimate market conditions and the fact that independent parties use the profit split method in joint ventures only.

Other methods 2: Transactional net margin method

The transactional net margin method (TNMM) tests the net profit margin of affiliated transactions relative to an appropriate base, such as costs, revenue or assets. In principle, the method works in a similar fashion as the resale-minus, and the cost-plus methods. The advantage of TNMM is that net profit margins may constitute a more stable base for comparisons than gross profit margins. In other words, net profit margins are less sensitive than gross profit margins to differences in functions performed, and direct

and indirect costs. A disadvantage of this method is that transfer prices used are assessed in isolation from other parts of the group of companies. The margin calculated for the part of the group that is investigated may result in unacceptably high or low profit margins in affiliated parts of the group.

Other approaches 1: Mutual agreement procedure

Article 25 of the OECD Model Treaty provides the opportunity to settle disputes with regard to double taxation by applying the mutual agreement procedure (MAP). The MAP can be called in by both the companies involved (Article 25, Paragraphs 1 and 2) and by the Member countries concerned. The dispute must be about issues for which the levying of taxes is not done in accordance with the provisions of the Convention, or about issues on the application of the Convention and the prevention of double taxation in those cases for which no other provisions have already been made. Here, a reference is made to the incidence of double taxation as a result of correcting transfer prices by a Member country involved. The OECD Model Treaty, though, does impose an obligation on states to make corrections to the opposite effect with respect to any correction by an other state. The ways in which Article 25 is incorporated in the legislation of states, will vary substantially, which will influence the elaboration of issues such as applicable terms, concurrence with other legal opportunities for objection and appeal, the treatment of collection interest and fines, etc.

Other approaches 2: Advance pricing agreements

An advance pricing agreement (APA) is an agreement by which, before any affiliated transactions are concluded, an applicable set of criteria is established for the setting of transfer prices during a certain period of time with respect to those transactions. These criteria can, for example, be in respect of the calculation method, measures for making comparisons, applicable adjustment, critical assumptions about future developments, etc. The initiative for an APA should be taken by the taxpayer, one or more parts of the group of companies, and one or more Tax Administrations. The concept of APAs has been created as a supplement to more traditional methods permitted by law and treaty instruments for resolving transfer pricing issues.

Other approaches that have not (yet) been recommended by the OECD

Taking the globalization of world trade into account, treaties increasingly include a provision for the resolution of disputes that result from treaties.

The equivalent of such a provision in the OECD Model Treaty, the MAP, has a severe limitation in that states are not obliged to work towards the resolution of any existing conflicts. Arbitration directed at resolving disputes could contribute to eliminating international taxation conflicts about, amongst other things, transfer pricing. The Arbitration Convention of the European Union offers already some opportunities for arbitration for resolving disputes.

Assessing transfer prices is a labour-intensive process, and requires a proper judgement of the prices to be used. The system causes high administrative expenses to the companies concerned, and can create uncertainty for a long time regarding the size of the liabilities of the group of companies. Therefore, those involved are searching for other possibilities to provide, simply and up front, certainty to companies with respect to their financial position on the one hand, without damaging the tax revenues of states concerned on the other hand. Thus, under the name “safe harbour” a set of simple rules exists for establishing transfer prices that will be accepted by Tax Administrations. These rules may be in respect of an easy to use calculation method, but also of the provision of information and the obligation to retain documents that are important for the judgement of a transfer pricing system. Until now the OECD rejects the application of these methods, particularly because the advantage of simplicity of “safe harbours” conflicts with regard to many aspects with the more complex, but theoretically superior methods such as have been described above.

5.4. Financial violations and money laundering

5.4.1. The place of money laundering

Through their illegal activities criminals generate proceeds. Parts of these proceeds from crime are invested in other criminal ventures, and thus remain hidden from the legal economy. Other parts of the proceeds are used by criminals for, amongst other things, keeping up their luxurious lifestyles, or for investments in the legal economy.

The combat against money laundering is important for several reasons. Firstly, targeted detection activities of money laundering by the police bring crimes to light that otherwise might have remained in the dark. Secondly, combating money laundering can help to prevent the underworld spreading its tentacles to the legal economy, and thus corrupting it.

Thirdly, money launderers use the legal economy, endangering the integrity of the financial and economic system. Finally, detecting money-laundering practices can prevent criminally obtained money from being used for criminal purposes.

In most countries, the combat is not a task of the Tax Administration. Usually special governmental agencies are entrusted with this task. However, the Tax Administration has to be aware when signals of money laundering occur. Money laundering and black money are overlapping concepts. Black money is all capital, kept concealed for whatever reason. Money that is hidden for fiscal reasons is called “pure black money”. Tackling black money is a duty of Tax Administrations. At an international level, the combat against tax evasion and tax havens is principally fought by the OECD. The fight against the laundering of money is the domain of the police, the office of the public prosecutor, the justice department and/or the finance department. The international combat against laundering practices of criminally obtained money is coordinated by the Financial Action Task Force on money laundering, the FATF.

Money laundering is a process that usually is described on the basis of the various stages in giving criminally obtained money a semblance of legality. Thus, the literature distinguishes three stages in the money-laundering process:

- (1) *Placement stage*: In this stage bank notes and coins are brought back into the financial system by depositing money in accounts at financial institutions. The use of straw men, and splitting sums into (many) small amounts for different accounts are common practice.
- (2) *Layering stage*: During this stage a series of sometimes complex financial transactions are made aimed at concealing the source of the capital that is brought back into the financial system.
- (3) *Integration stage*: In this stage criminally obtained capital that now has an appearance of legality is invested in the legal national and international economy.

Also, investments will be made in securities, luxury goods, property or works of art. Some authors distinguish an additional fourth stage that precedes the above three stages, the stage of the changing money, the “pre-laundry”. Here, the criminally obtained cash is transferred into another

form of money, such as cheques, notes of different denomination or another currency.

Since the terrorist attacks of 11 September 2001, the eyes of many have been opened to see that the financial system is not only exploited by criminals. Terrorists, too, abuse the financial system in various ways. The most important abuse is identical to the laundering pattern employed by criminals. For their funding, terrorist organizations depend upon the proceeds from crime, for instance from smuggling cigarettes, or trading prohibited addictive substances.

These profits are then laundered in order to finance terrorist activities. Yet, for financing their outrage, terrorists also abuse the financial system in an apparently legal fashion by providing money to so-called sleeping cells for their maintenance. For this reason the FATF has formulated new recommendations that are tailored to fighting the financing of terrorists.

5.4.2. International cooperation in combating money laundering

5.4.2.1. Financial Action Task Force on money laundering (FATF)

In 1989, the G7 countries created the FATF with the objective of combating the laundering of money from drugs. The FATF is no formal organization and has, therefore, no formal powers. All decisions by the FATF are taken by its so-called plenary. Decisions are usually based upon proposals by the secretariat. The chairman of the plenary is elected annually for a term of one year. The secretariat is located at the OECD. Cooperation rests upon peer pressure, which until now has proven to be highly effective. At present, 29 countries, 2 organizations and 17 observers have joined the FATF. The participating countries subscribe to the recommendations, and commit themselves to their implementation. The 40 recommendations include basic rules for the way in which money laundering can be tackled.

Initially, the 40 recommendations were only in respect of laundering money from drugs. Later their scope was extended to all “serious” crimes. What constitutes a “serious” crime, differs from country to country. Most countries have designated crimes as “serious”. These crimes are referred to as “predicate offences” (“basic crimes”). By the end of 2001, the FATF formulated eight new recommendations that are geared to combating the funding of terrorism.

After the 40 (now 48) recommendations were adopted, it was decided that the implementation of the recommendation by individual countries should also be monitored. For this purpose two monitoring instruments are used: “mutual evaluations” (checking individual countries by others) and the self-assessment exercise.

5.4.2.2. Non-cooperative countries and territories

The purpose is to make a blacklist of countries which take insufficient measures against money laundering, for which fixed standards and criteria are used. The blacklist is criticized for being rather arbitrary, and because it is used by G7 countries for foreign policy purposes.

In 2000, a list of 25 criteria has been agreed upon against which countries can be tested. If a country meets one single criterion, it will not be on the blacklist immediately. Only serious cases, which score positively for a substantial number of criteria have been blacklisted. The countermeasures can vary from a warning against transactions with certain countries to suspending all financial traffic. The effect of the blacklist appears to be positive. Almost all countries that have been entered, or were threatened to be put on the list, have responded rapidly by enacting laws and establishing reporting agencies.

5.4.2.3. Reference Guide

The Reference Guide is a compendium to facilitate international cooperation. It consists of two parts. The first part is the “telephone directory” providing for each FATF Member a brief description of the various organizations involved in combating money laundering, including contact persons. In the second (non-public) part, on the basis of a number of standard items an effort is made to provide insight into the possibilities for each country to exchange information on an international level. Thus, attention is paid to obligations of financial enforcement bodies to keep information secret, to the reporting offices, and to the way in which international legal assistance can be arranged.

5.4.2.4. Other organizations comparable to the FATF

In addition to the FATF, other comparable organizations are active: the Caribbean FATF, the Asia/Pacific Group (APG), and the Gafisud (South

America). Two similar organizations for Eastern and Western Africa are at present still being established. The FATF style bodies have adopted largely the same procedures as the FATF. Members meet periodically, share knowledge, hold typology meetings and review each other on the basis of peer pressure. The FATF serves as an umbrella organization.

5.4.2.5. Multilateral banks

Various multilateral banks provide technical support, including on the subject of combating money laundering. For this purpose the multilateral banks have their own programme. During FATF meetings information is exchanged and coordination of activities is arranged between the multilateral banks and the FATF. For this purpose, the World Bank, the Inter-American Development Bank (IADB), and the Asia Development Bank have joined the FATF as observers.

5.4.3. Money laundering and the Tax Administrations

5.4.3.1. Introduction

Combating money-laundering activities is not the prime responsibility of Tax Administrations. But combating fraud in the area of taxation also contributes to upholding the financial integrity of the government, and to enforcing laws and regulations for ensuring the integrity of the functioning of the professions and of trade and industry. In many instances money-laundering activities coincide with the government losing tax revenue. This is not always the case; for instance if money of a criminal origin is reported as fictitious turnover of a company, which even works out in the advance of the treasury. Another possibility is to launder money by fictitious changes in value of the capital component to be bought or sold, such as works of art, antiques, collections, property and vintage cars. Depending on the fiscal legislation, any profits thus gained are fully tax exempt.

5.4.3.2. Money laundering within the company: fictitious turnover

In many cases an entire chain of transactions involving large numbers of persons is used in the laundering of money. The various stages of the money-laundering process within companies can take place randomly.

Delivering goods or services, or the reverse process of acquiring goods or services, can be done entirely in a foreign country. Criminally obtained money is booked as fictitious proceeds in order to feign a legal origin. Entering this turnover combines the placement stage, the layering stage, and the integration/justification stage. The opportunities for laundering money differ according to the type of business.

Companies with a low gross profit margin usually have a large flow of goods (timber trade, petrol stations, etc.) and may supply both end users and distributors. It is important to identify unusual patterns in the flows of goods (frequency of purchase, purchase prices, type of goods, etc.). Because of their sheer sizes, though, these flows of goods are difficult to trace. Profit margins of individual batches or series are difficult to determine, but ultimately the point is to detect unusual patterns. For individual companies this is a labourious construction, because of the restrictions associated with physical goods (warehousing, stock accounts, etc.). Moreover, additional invoices must be made to account for price differences. If a company actually participates in the economic process, the construction for money laundering requires complex accounting with a corresponding large chance of being found out. The accounting problems are less serious if deliveries are made to affiliated companies, or in the case of trading in goods with high profit margins (hospitality business, clothes, jewellery, etc.). For goods with very high profit margins, destroying the goods bought can even be preferred to selling them, because the fictitious turnover in itself results in satisfactory returns on money laundering. Proceeds of 40% to 50% of “net” cash are usually quite acceptable to the money launderer. The possibilities of exercising appropriate enforcement become fewer, if no physical goods are used, but services and capacity. With regard to capacity, this can be both unused capacity and fictitious capacity (hotels, cinemas, telecommunication, etc.) These possibilities are restricted by data collections that are linked to the accounting system (hotel register, number of admission tickets of events, lease contracts, etc.). The fewest leads are provided by “intellectual capacity”, such as consultancy activities of training courses or fictitious “pure” services (which, by their nature, are practically impossible to trace). If the services that are claimed to have been provided are not too implausible, it is virtually impossible to find out what the real services were, certainly if project or overall fees are charged.

5.4.3.3. Laundering money within the company: fictitious expenses, assets and loans

Fictitious expense accounts are the counterpart of the fictitious sales. Fictitious expenses result in concealment. This scheme is never used on its own, because fictitious expenses of one company are larger than the laundered proceeds (sales) of another company. If necessary, an entire chain of associated companies can be created in which continuously additional expenses and associated revenues are feigned. A distinction can be made between goods or services that are actually delivered and that are overpriced, and goods or services that have not been delivered at all. Within each category various accounting variants can be used.

Introducing fictitious balance sheet items is based upon the same line of thought as fictitious expenses. For this scheme, buying non-existent assets can be feigned, or the purchase price of assets can be overstated, or fictitious debts can be created. The beneficiary of the money-laundering practices will obviously have to be chosen with great care. The fictitious balance sheet items serve for concealment, and the linked obligations to justify revenue.

In order to transfer money back into the monetary circuit of the company, loans are used as well. If direct loans are used, the money is lent to the company without any intervention by a financial institution. This can be done directly through laundering, but usually a very large number of carefully selected companies are used, with or without any trusts. If non-direct loans are used, a registered financial institution is brought in, which extends the loan on the basis of security provided, which, in turn, is based upon black money. In general, the financial institution does not know the real nature of the security provided.

5.4.3.4. Money laundering and the company: other aspects

Money can flow to and from companies in various forms. Cash will be used particularly in industries and lines of business in which cash receipts are not uncommon (trade companies and hospitality business). If placement was realized elsewhere, money can be transferred through the banking circuit. Similar to this are payments through credit cards. Prior to this, though, the balance of the contra-accounts of credit cards must be made sufficient. Often these are cross-border transactions. International cooper-

ation and exchange of information are preconditions to combat these practices effectively.

Finally, arrangements must be made to withdraw the money laundered from the company to ensure it flows into the intended pockets. Which method is chosen depends, in part, upon the nature of the company. One of the methods is to distribute the money laundered as dividends, as a nicely operating company (as a result of additional fictitious sales) will earn profits. Because of the extra sales its value has increased. Another method of withdrawing money is the company extending loans, or making available benefits other than in money (cars, travel, etc.).

5.4.3.5. Money laundering in private life

Money can also be laundered by individuals and, depending upon the legislation, it can even be done free of tax. Laundering money in private life usually involves some form of spending on capital components. The most important money-laundering practice in private life is through transactions involving capital components. Goods can be sold for prices that are too high. This method is similar to those involving fictitious sales. As a result of the higher price paid by a person who pretends to be a third party, a seemingly legal capital is created. The goods are usually valuables, such as works of art or real estate.

In addition to the relatively “clean” capital gains in selling and buying schemes, money can also be laundered through investments. For this, different methods can be thought of, for instance using foreign or domestic investment portfolios. Multiple investment portfolios are intended to cash gains and losses selectively on investment accounts. Gains are accounted for in the normal portfolio and losses in the foreign portfolio that was created with black money. The accounts of the transactions are drawn up afterwards. As a result of the distribution of gains, the normal portfolio will show unusual profit margins, but by including the occasional loss, any suspicion can be removed. This money-laundering practice, though, requires a middleman willing to cooperate in the investment transactions. If a sufficient number of people participate, the scheme can opt for using fictitious profitable transactions with investments.

5.4.3.6. Other money-laundering methods

Other methods are:

- Investments in a company. This can be done by buying shares, possibly for a price that is too low. The gain may consist of dividends distributed or of realizing a profit at the sale of the shares. Also, investments can be made in companies engaged in unlawful operations in order to support their criminal activities or in companies that have opportunities to combine lawful and unlawful activities (hotels, servicing industry, etc.).
- Lending money to a company, possibly followed by lending back from the same company. This practice can best be used in the case of relatively small companies with lawful activities in which financial supervision will be slight. These loans may or may not be arranged through the intervention of a financial institution. Obviously, the same practice can be used by individuals.
- Buying and selling very valuable goods, such as gold or diamonds. Payment may be through banks or in cash. The “paper trail” is cut and the goods are simply sold elsewhere.
- Using guarantees and security. Against collateral funded by black money that is handed to a financial institution as surety, this financial institution will provide security. By levying execution of this security, “white” money is received and the black money is collected by the bank. This scheme can also be used by companies.
- Financing old-age pensions with black money. This can be in the form of buying an annuity life insurance or taking out a life insurance. The much later payments cannot be traced back to the criminal proceeds, and thus the money is laundered.
- Participating in games of chance (in casinos, fruit machines, etc.). By declaring fictitious gains from games of chance at home or abroad, “white” money is created. Other than gains, any losses by games of chance result in gains by the organizer of the games of chance. If the money launderer is also the organizer, he may opt for the gain practice or the loss practice. A variant of fictitious gains from games of chance is actually obtaining prizes from games of chance. Two methods are known. Firstly, buying winning lottery tickets, and secondly, playing games of hazard with a more or less certain winning percentage.
- Direct consumption paid through credit cards that are linked to balances in bank accounts financed by black money. In most cases, these bank accounts are in banks in a foreign country.

Example: Knowledge Centre on Money Laundering, the Netherlands

Since 2001, the Netherlands have a Knowledge Centre on Money Laundering as part of the Tax Administration. The objectives of the Centre are:

- bringing together knowledge, information, experiences and expertise in the area of money laundering;
- analysing, processing and disseminating this information;
- incorporating and assuring this information within the enforcement process and within the organization.

The Knowledge Centre will produce output in the following fields of interest:

- Risk indicators for concentrating and intensifying examination and detection. It lies down and documents the fiscal implications of the various forms of money laundering. Following this, it develops criteria (in collaboration with other parts of the Tax Administration) for the selection process. It also signals developments that may offer starting points for combating money-laundering practices. Examples of such developments are the enactment by a country of new laws and regulations or the introduction of new currencies.
- Contact point. The Knowledge Centre serves as a focus for internal and external contacts in the area of combating money laundering.
- Operational support. Where appropriate, officers of the Tax Administration are provided support for resolving questions and problems with regard to the laundering of money (help desk function).
- Detection and investigation activities that are likely to result in criminal prosecution. Each year the Knowledge Centre contributes to initiating a number of very large investigations for bringing to light and combating fraud and money laundering.
- Thematic approaching laundering. Within the framework of examination it is both more effective and efficient to tackle (parts of) the issue of laundering money thematically and successively, as it is impossible to deal with all aspects simultaneously, given the limited capacity available. The Knowledge Centre contributes to formulating the themes to be taken on.
- Knowledge and experience bank on laundering money. The knowledge and experience bank is based upon the knowledge of and experience with combating money laundering in officers of the Tax Administration of the Netherlands. The main object is information and knowledge of incidents and other facts (money-laundering practices and methods and facts of cases, in addition to jurisprudence and case

law). The databank will provide information both proactively and upon request.

- Money-laundering library. A (partially electronic) library is at present being built.
- Training modules of money laundering. A training module on laundering money and combating it is being created for employees of the Dutch Tax Administration. The purpose of this training module is to enhance the expertise of its officers.
- Publications. The combat against money laundering intensified, and the reputation and the identity of the work of the Knowledge Centre can be strengthened by publishing studies and articles internally and externally.

5.5. E-commerce

5.5.1. Introduction

The development of electronic trade within the information society offers important opportunities for employment, especially in medium-sized and small companies, as well as for growth of business and industry, and investments in innovation. Electronic commerce also contributes to strengthen the competitiveness of industry, on the condition that the Internet is accessible to everybody. As a consequence of all these developments, the distance between the producer and the consumer of goods is becoming smaller and the value chain changes because many chains lose their reason of existence.

With respect to e-commerce, authorities have two duties for the levying and collection of taxes. Firstly, they must create conditions in the fiscal arena that do not interfere with electronic commerce. Secondly, at the same time though, the basis for taxation should be maintained.

From a more general perspective the development of services within the information society is hampered by legal obstacles, impeding global competition. These obstacles have their origin in differences in legislation, as well as in the insecurity before the law with respect to national regulations applying to these services. This insecurity is with respect to both the levying of taxes and the provisions for examination. Since 1997, the OECD has played a crucial role in establishing an international consensus on the tax treatment of electronic commerce. At the 1998 Ottawa Conference, a set of

Taxation Framework Conditions (TFCs) was presented to govern taxation of cross-border electronic commerce. One of the main points of these TFC's is the principle of neutrality between electronic and conventional commerce, and between taxpayers in similar situations. In view of the importance of the results of the Ottawa Conference, they will be discussed in some detail later in this chapter (see section 5.5.3.).

Virtual money

In the economic sphere, the advance of global e-commerce and transnational capitalism has been paralleled by the revival of local and "informal" economies. Both developments make use, in part, of new forms of money, based on communication and information technology (CIT). It is widely thought that these could successfully challenge the state's monopoly and control of monetary production.

CIT is literally *transforming* money. After its commodity and paper incarnations, money is now (it is widely thought) becoming "virtual" – as in, for example, the electronic transmission of payments in the banking system, or in "electronic purses".

Circuits of economic exchange obviously have been able to create their own *media of exchange* that are based, to some extent, on *interpersonal trust and confidence*. However, if the base for the confidence has no foundation beyond the economic exchanges themselves, the media of exchange will remain what anthropologists refer to as "limited purpose money". The Internet is seen by some as the means for a limitless extension of such networks.

This change in the mode of monetary transmission has some important implications; but perhaps we should note at this early stage that there is a great deal of rash hyperbole on the novelty of "dematerialized" money. After all, the "book money" in 16th century Italian banks was just as "virtual" when it was transported through time and space by the stroke of the pen.

There are a number of issues here concerning fraud, money laundering, tax evasion and so on. It is not clear whether electronic forms of money will lead to an increase in or a reduction of such activities. This is largely an empirical question and until we move nearer to a cashless economy we cannot be confident about outcome. Other things being equal, however, no form of money can be as anonymous and untraceable as hard cash, the

foundation of the large “black” economies in even the most economically advanced societies. However difficult it might be in practice, electronically transmitted money is traceable.

5.5.2. To which services does e-commerce extend?

The services of the information society are considered to include all services that under normal circumstances upon individual request are delivered to a buyer of services at a distance, by means of electronic equipment for the processing (including digital compression) and recording of data. This definition does not include any services that do not involve processing and recording data. The services that are covered by this definition are provided to a large variety of economic activities that are performed online and, in particular, to the online selling of goods. Activities such as the actual delivery of goods or the providing of off-line services are not covered by the definition.

Examples of activities that are covered by the definition, and that are not:

The services of the information society are not restricted to those for which online contracts have been concluded. They also include services for which the customer does not have to pay, provided these services constitute economic activities. Examples are services that consist of offering online information or commercial communication and services that provide tools for searching and retrieving data, and for obtaining access to information. The services of the information society are also considered to include passing on information through a communication network, providing access to a communication network or making accessible information that is provided by a recipient of a service. These services include, among other things, web site supply, web hosting, supply and updating of software, supply of images, text and information and making databases available, supply of music, films and games and supply of distance teaching.

Activities for television and radio broadcasting are not considered services of the information society as they are not delivered upon individual requests. Services, though, transferred from point to point, such as video plays upon request or transmitting commercial communication through electronic mail, are services of the information society. The use of electronic mail or equivalent individual communication facilities, for instance, used by private persons for purposes outside their occupational or profes-

sional activities, including the use of these communication facilities for concluding contracts between those persons, is not a service of the information society. The contractual relationship between employee and his employer is not a service of the information society. Activities which, by their nature, are not delivered from a distance and which can be delivered by means of electronic equipment, such as legal audits of invoices of companies or medical consultation which requires a physical examination of the patient, are not services of the information society. Other activities that are not considered services of the information society are the misuse of the Internet for digifraud and cybercrime.

5.5.3. The Ottawa Conclusions

During the Ottawa Conference of the OECD in October 1998, a consensus was reached on the fact that governments should apply the same principles of taxation for e-commerce activities as for conventional activities of trade and industry. As quoted from the proceedings, these principles (the TFCs) include:

- neutrality: taxation should seek to be neutral and equitable between forms of e-commerce and between conventional and e-commerce, avoiding double taxation or unintentional non-taxation. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation;
- efficiency: compliance costs to business and administration costs for governments should be minimized as far as possible;
- certainty and simplicity: tax rules should be clear and simple to understand, so that taxpayers know where they stand;
- effectiveness and fairness: taxation should produce the right amount of tax at the right time, and the potential for evasion and avoidance should be minimized;
- flexibility: taxation systems should be flexible and dynamic to ensure they keep pace with technological and commercial developments.

In the field of consumption taxes, the core elements of the TFC's were developed as follows:

- Rules for the consumption taxation of cross-border trade should result in taxation in the jurisdiction where consumption takes place and an international consensus should be sought on the circumstances under which supplies are held to be consumed in a jurisdiction.
- For the purpose of consumption taxes, the supply of digitized products should not be treated as a supply of goods.
- Where business and other organisations within a country acquire services and intangible property from suppliers outside the country, coun-

tries should examine the use of reverse charge, self-assessment or other equivalent mechanisms where this would give immediate protection of their revenue base and of the competitiveness of domestic suppliers.

In elaborating these principles and applying them to cross-border trade in services and “intangible property”, two questions should be answered; “Where does their consumption take place?”, and “Which collection mechanisms can support the practical operation of that principle?” With regard to the place of consumption (and thus the place where tax is levied) a distinction is made between “*business-to-business*” (B2B) transactions and “*business-to-consumer*” (B2C) is made. For B2B transactions the place where the recipient of the services is established is the place where tax is levied. For B2C transactions the usual place of residence of the recipient is decisive for the levying of taxes.

From the proceedings of the Ottawa Conference:

The most viable collection mechanisms to support the practical application of such Guidelines are identified by the following principles:

- for B2B transactions the use of reverse charge or self-assessment mechanisms; and
- for B2C transactions, some form of simplified registration-based mechanism of non-resident vendors should be considered. In the medium to long-term technology-facilitated mechanisms offer potential to support new methods of tax collection.

5.5.4. Verification of the status and place of the business customer

From the proceedings of the Ottawa Conference:

In order to determine the correct taxation rules, the vendor must determine whether the buyer is a business customer or a private customer. To do this, the first step should be for the vendor to ask the question of the customer. As long as the reverse charge mechanism allows cross-border business customers to receive the services without addition of the tax by the vendor, consumers will have a financial incentive to hold themselves out as a business. Thus, further verification is necessary.

To this end, businesses should be requested to use verification methods as follows:

Digital Certificates: Some jurisdictions issue digital certificates for business-to-government (B2G) transactions and some companies issue digital certifi-

cates to their customers. Where these digital certificates are interoperable and of a high integrity, tax authorities may take into account the tax decision of the business and provide some administrative easements. The integrity of such certificates would include considerations about who issued the certificate, how the information contained on the certificate was validated and whether there is scope to include particular information about VAT registration status and jurisdiction. Under these conditions this approach is probably the most secure and accurate. However, use of digital certificates is not yet widespread and the integrity and interoperability issues (e.g. with certificates of residence used in income tax matters) needs to be considered.

Verification of VAT/GST Registration: Today, at least in some jurisdictions (e.g. the European Union), verifying the status of the customer is, in certain circumstances, part of the taxing decision process. The relevant criterion is whether the customer is registered for VAT purposes or not. In those jurisdictions where the status of the customer has significance, there are mechanisms to support the decision-making process. In the case of the EU, the VIES (VAT Information Exchange System) system fulfils this role online. Other jurisdictions may have similar systems whereby it is possible to check the validity of the VAT/GST registration number. Such systems should guarantee publicly available instant answers. It should be noted, however, that such methods will not be available in all jurisdictions, in which case other methods (indicia) should be used.

Other Indicia: In the absence of the above elements, or when the customer declaration is obviously in contradiction with some clear indicia, business should take other indicators into account. Payment data such as bank transfer, more commonly used for large-scale transactions than credit cards, and payment arrangements in contracts may be used as a complementary verification method. The nature of the supply should also be considered. For example, a supply of digitized music or films, with no embedded intellectual property rights, is more likely to be to a private recipient rather than a business. Conversely, business accounting software is much more likely to be sold to a business rather than a private person. Such an indicator will not necessarily be determinative given that some products may be purchased by both business and private customers. Taking all indicia together should, however, assist business, and revenue administrations, in determining the status of the customer.

The jurisdiction of the business customer should be determined in the same way and at the same time as its status. When the purchaser is proved to be a business with a foreign digital certificate or VAT number, the vendor can zero rate the transaction without any other obligation. Where the vendor cannot regard the client as a business, the presumption is that the customer is private and VAT should be charged accordingly.

5.5.5. Business presence

From the proceedings of the Ottawa Conference:

The “business presence” is, in principle, the establishment (for example, headquarters, registered office or a branch of the business) of the recipient to which the supply is made.

The main rule provides a general approach. Thus, in a situation where a recipient with several locations, such as a headquarters in one country and branches or subsidiaries in other countries, the business presence should be considered as the establishment to which the supply is made. A recipient’s degree of business presence in a foreign jurisdiction can encompass a wide range of activities and may vary from a locally incorporated legal entity to a very limited presence (e.g. property presence through computers). Business presence should be a location of the recipient capable of acquiring or receiving supplies of services or intangible property. In most situations, the place of consumption for B2B transactions will be easily determinable, as the facts will unequivocally indicate the business presence consuming the services or intangible property. This will be the case where a business presence (headquarters, branch or subsidiary) located in a jurisdiction contracts with the provider, pays and fully consumes the service or digital property.

Nevertheless, in some circumstances, the use of the same service (e.g. access to a database) or intangible property (e.g. software) may be shared among various entities of the recipient (headquarters and branches or subsidiaries). In cases where there is such a choice of locations, the business presence to which the supply is made should be the principal presence of the recipient, even if the service is fully or partially used or consumed by a different entity in another jurisdiction. The principal business presence would be determined based on, among other things, the contracting business presence. Taxation in the jurisdiction where the principal presence is established would not, in most cases, diverge from taxation in the jurisdiction of consumption, as the service will be charged back to subsidiaries.

...

Such an approach should normally be applied only in the context of a reverse charge or self-assessment mechanism. This fallback rule allows countries to require a business presence in their jurisdiction to account for tax even though that business presence is not the principal business presence of the recipient. The application of this fallback rule should be limited to situations where there is a risk of distortion of competition or tax avoidance, double or involuntary non-taxation. This would be the case when one or more consuming entities are not entitled to fully recover the input tax.

It is recognized that implementing this Guideline will not always result in taxation in the actual place of consumption. Under a “pure” place of consumption test, intangible services are consumed in the place where the customer actually uses the services. However, the mobility of communications is such that to apply a pure place of consumption test would lead to a significant compliance burden for vendors.

Verification of the status of the private customer

The guiding principles on definition of jurisdiction of the customer set out below, should be seen as minimum requirements in the absence of any better information available to the supplier. They should be capped to have application for low value casual online transactions only and they should be periodically reviewed.

The vendor will need to ask the customer the country of residence. It is clear that this method, when used as the only means of determining the jurisdiction would not be fully reliable. Without further verification the answer is of limited value, but, nevertheless, it may be regarded as an important element together with a range of other criteria consistent with business practice and importance of the transaction.

Hence, in addition to the customer declaration as part of the transaction, businesses are expected to use some verification methods as follows:

Tracking software: This method to check customer’s declaration is based on the use of IP (Internet Protocol) number tracing technology. This technology is already available and varying degrees of accuracy (up to 96%) are claimed for such systems. It is increasingly being used by Internet businesses for targeting advertising and for fraud control purposes and is incorporated into vendors’ web sites. The advantage of technology-based verification is that it can be easily and relatively cheaply incorporated into online transactions. Whilst not providing 100% accuracy, any tool that provides verification with around 90% success must be considered viable.

Payment mechanism: It is unlikely that payment systems themselves, such as credit card information, provide suitable means of verification. However, as technology and payment systems develop this area will be kept under review.

Product features: The nature of the product being sold may also help to give an indication of customer jurisdiction. A site that is clearly targeted at domestic customers through use of language, currency and market limitations and other indicators is unlikely to be making many sales outside of its own jurisdiction. Again, such an indicator is not conclusive but should form an important element in the overall approach.

Digital certificates: These may well offer the best possibilities in the long term, but their use is even less widespread among private consumers than among businesses. Consequently, this can only be considered as a medium to long-term tool for most jurisdictions.

5.5.6. Recommended approaches to tax collection mechanisms

From the proceedings of the Ottawa Conference:

Three tax collection mechanisms are typically used in consumption tax systems: registration, reverse charge/self-assessment, and collection of tax by customs authorities on importation of tangible goods. Under a registration system, the vendor of goods and services registers with the tax authority. Depending on the design of the tax, the vendor is liable to either pay the tax due on the transaction to the tax authority, or collect the tax payable by the customer and remit it to the tax authority. Under the reverse charge/self-assessment system, the customer pays the tax directly to the tax authority. Collection of tax on imports of tangible goods by customs authorities is common to virtually all national consumption tax systems where national borders exist for customs purposes.

Since registration and self-assessment/reverse charge mechanisms are currently in use in the majority of consumption tax systems, they represent a logical starting point in determining which approaches are most appropriate.

Emerging technology has the potential for development of innovative approaches to tax collection, and the Global nature of electronic commerce suggests that collaborative approaches between revenue authorities will become increasingly important. In the short term, the traditional approaches to tax collection remain the most promising, although the application of these may vary according to the type of transaction.

Work to date shows that, unlike the core place of consumption itself, different tax collection mechanisms can be used without creating international distortions in the market place. In addition, it points towards the conclusion that, over the medium term, a coherent set of options can be offered to the business for business-to-consumer transactions.

5.5.7. Recommended approaches

5.5.7.1. Business-to-business transactions

From the proceedings of the Ottawa Conference:

For cross-border business-to-business (B2B) transactions (of the type referred to in the Guidelines), it is recommended that where the supplying business is not registered and is not required to be registered for consumption tax in the country of the recipient business, a self-assessment or reverse charge mechanism should be applied where this type of mechanism is consistent with the overall design of the national consumption tax system.

This has a number of key advantages. Firstly, the tax authority in the country of consumption can verify and enforce compliance. Secondly, the compliance burden on the vendor is minimal. And thirdly, it reduces the revenue risks associated with the collection of tax by non-resident vendors.

Member countries may also wish to consider dispensing with the requirement to self-assess or reverse charge the tax in circumstances where the customer would be entitled to fully recover it through deduction or input tax credit.

5.5.7.2. Business-to-consumer transactions

From the proceedings of the Ottawa Conference:

The OECD has not reached any firm conclusions on the effective tax collection mechanisms in respect of business-to-consumer (B2C) cross-border transactions of services and intangible property. Technology may well provide turnkey solutions through development of innovative tax collection mechanisms. There may be a role for third parties or for revenue authorities in the jurisdiction of the vendor. Development of collection mechanisms will need to take account of the wide diversity of businesses, possibly allowing for a menu of agreed options from which each business may select its preferred mechanism.

In the interim, where countries consider it necessary, for example because of the potential for distortion of competition or significant present or future revenue loss, a simplified registration system (consistent with the overall design of the national consumption tax system) may be considered to ensure the collection of tax on B2C transactions.

Where countries feel it appropriate to put into effect a registration system in respect of non-resident vendors of services and intangible property not currently registered and not required to be registered for that country's tax, it is

recommended that a number of considerations be taken into account. Firstly, consistent with the effective and efficient collection of tax, countries should ensure that the potential compliance burden is minimized.

For example, countries may wish to consider registration regimes that include simplified registration requirements for non-resident suppliers (including electronic registration and declaration procedures), possibly combined with limitations on the recovery of input tax in order to reduce risks to the tax authority. Secondly, countries should seek to achieve neutrality so ensuring that taxpayers in similar situations carrying out similar transactions are subject to similar levels of taxation. Finally, countries should consider appropriate control and enforcement measures to ensure compliance, and recognize, in this context, the need for enhanced international administrative co-operation.

5.5.8. Other constraints

Not only fiscal measures are required to initiate and to enhance the development of e-commerce. Legal protection of the consumer, promoting commercial communication, and eliminating interfering legislation in the area of contracts are issues that also must be regulated and resolved.

In order to effectively protect the public interest, checks on (the quality of) services of the information society must be made at the source of the services. This requires the assurance that competent authorities will provide this protection not only to citizens of their own country, but to all citizens. This applies equally to the sales at a distance of financial services to consumers.

Commercial communication is essential for financing services of the information society. Commercial communication, including advertisements on price reductions, promotional offerings and games, must be transparent in the interest of the consumer and in view of the fairness of the transactions.

Countries must amend their legislation if it includes requirements, particularly of form, which interfere with or prevent concluding contracts electronically. The examination of the legislation to be amended must be systematic and must cover all stages and procedures which are required for entering a contract, including the filing of contracts. These amendments must result in an electronically concluded contract indeed being implemented out.

Directive European Community 2002/38/EC

No disadvantage of competition European suppliers as a consequence of the LAW “VAT on E-commerce” (proposal of law)

As a consequence of the growth of economic activities by e-commerce the Council of the European Community has accepted the directive E-commerce on 7 May 2002. The aims of this directive are:

- a clear system of imposing tax on e-commerce; and
- to arrange a fair competition for all European companies.

The Members of the European Community (EC) have the obligation to make law of this directive. The Netherlands have made a proposal for law.

Besides the composing VAT to the companies who receive the products, the Dutch proposal arranges a possibility of registration for the non-European suppliers which delivers electronic services to consumers and non-businesses. The suppliers can choose for the registration in one of the EC Member States to pay VAT for all E-commerce activities in all EC Member States. The Member State of registration has to divide the received VAT among the other Member States.

The consequences of the proposal of law can be summarized in a scheme:

Client	Supplier in the EC		Supplier not in the EC	
	Proposal	Present situation	Proposal	Present situation
Company in the EC Member States	VAT obliged in the EC Member State of the client (VAT obligation is shifted to the client, unless the country of the supplier is the same)	VAT is obliged in the Member State of the supplier	VAT is obliged in the Member State of the client (VAT obligation is shifted to the client)	No VAT-obligation
Private person in the EC Member States and non-business	VAT is obliged in the Member State of the supplier	VAT is obliged in the Member State of the supplier	VAT is obliged in the Member State of the client; payment in	No VAT obligation

Client	Supplier in the EC		Supplier not in the EC	
	Proposal	Present situation	Proposal	Present situation
Outside the EC (companies and private persons)	No VAT obligation	VAT is obliged in the Member State of the supplier	the Member State of registration (specific rules)	
			No VAT obligation	No VAT obligation

5.5.9. Internet and audit and fiscal risks

Of all e-commerce transactions, the international B2C transactions, combined with digital delivery, raises the most questions related to levying and collecting of taxes at present. Although there is the impression that these transactions comprise only a few per cent of all e-commerce transactions. Lack of confidence stands in the way of the further growth of the B2C transactions. On the one hand, the industry does not trust the consumers when it comes to multiplying the digitally delivered products, for it is only one push on the button for consumers to multiply the product they just bought and spread it (for free) among friends and family. On the other hand, there is a lack of confidence among consumers in unknown companies (abroad). For instance, how do you force the delivery of the product after you have paid for it, and what if the product is of poor quality.

Though the number and volume of digital B2C transactions is still very modest, a number of risks, related to the use of Internet can be distinguished. These risks can be general, fiscal or audit related.

Not discovering entrepreneurs is a general risk, leading to a registration gap. This gap occurs especially with new companies, mostly established abroad. Because there is no physical transport and delivery of goods and B2C transactions tend to cross the borders, it is difficult for the national Tax Administration to detect these companies if they do not report themselves. It is necessary to increase the knowledge of the tax auditors and provide sufficient means to adjust to these new developments.

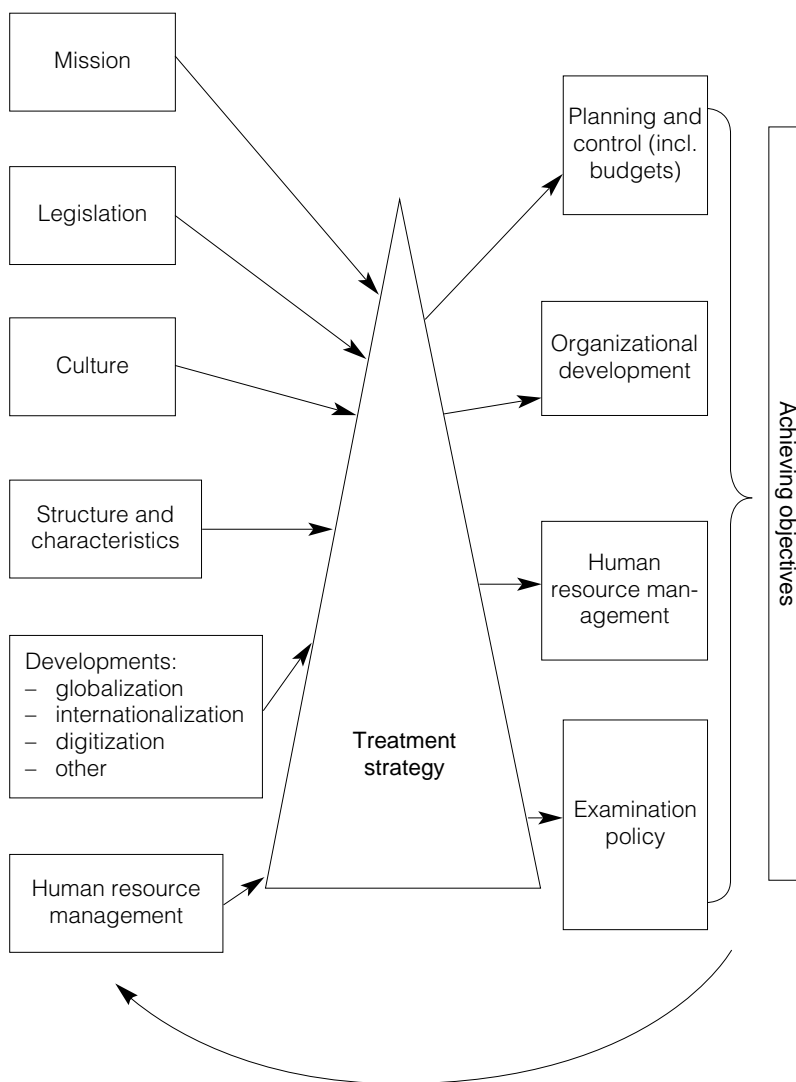
In the field of international tax laws new problems arise about terminology. Existing definitions must be reconsidered to include notions of the world of Internet in the language of international tax laws. For example:

- when is a server a permanent establishment;
- where is the management located;
- how does one divide the results within the concern;
- are payments for e-commerce to be considered as royalties or as profit (of interest for the possibility of levying a source tax);
- more companies (so also the Tax Administrations) get involved with the problems of multinational companies; and
- how do you establish the place of the transaction, how do you know whether VAT has to be paid and if so, how do you levy and collect VAT?

The development of Internet creates also new problems in the field of auditing. More and more companies keep their books electronically – these books can often only be approached with the help of EDP techniques. Companies increasingly keep and retain their books abroad. These developments lead to new challenges to access and to enter the books. Auditing the digital bookkeeping on aspects as authenticity and integrity, together with the introduction of new forms of electronic payment, necessitates new auditing techniques.

APPENDIX 1

Mission and context Treatment strategy Tools Objectives



Appendix 1

APPENDIX 2

Duties and organization of tax inspections within the State Tax Administration Agency

Within the State Tax Administration Agency, the administrative body charged with tax inspection duties is the Department of Financial and Tax Inspection (*Departamento de Inspección Financiera y Tributaria*). However, it is not the only one, as certain bodies of the Department of Customs and Special Taxes also perform inspection duties in certain areas of taxation.

Tax inspection duties (validation and verification)

These duties are as follows:

- Verification and investigation duties. This department checks the accuracy and veracity of allegations and circumstances submitted by taxable persons or liable parties on any declarations and communications required for each tax. It investigates the possible existence of unknown or partially unknown factual elements or other antecedents affecting taxes. It determines the accuracy of tax liability calculations performed by taxable persons or by parties who withhold taxes for collection. Further it establishes, where applicable, any corrective action considered necessary, based on current tax liability and payment status.
- Information-gathering actions. The purpose of these actions is to become aware of information or antecedents of any nature in the possession of a person or entity and which affect the tax liability of other persons or entities.
- Assessment of goods, rents, products, rights and assets in general, of public or private persons or entities for the purpose of appraising or verifying their declared value, by any of the means allowed by legal mandate.
- The creation, through the government bodies as required in each case, of economic and financial studies by individual, sector or region, as well as technical, computer-based or other analyses, insofar as they may be of interest for inspection activities.

Furthermore, certain individual tax inspection offices may perform duties that are generally performed by the Agency's tax collection management bodies, but in the case of "large taxpayers" (those whose total volume exceeds 1 billion pesetas in the previous fiscal year, that is about USD 6.7

Appendix 2

million) these duties are performed by specific bodies that are part of the Agency's central or peripheral inspection services: the large company management units. These management functions are mainly comprised of:

- receipt of declarations, appeals, queries and other documents related to tax issues, as well as their consideration and processing;
- formal verification of the information laid out in the tax documents presented and performing tasks in preparation for automated handling of the information;
- issuing formal requests as required, mainly due to declarations that must be presented or whose presentation is incomplete;
- issuing provisional official settlements when the evidence in possession demonstrates the occurrence of a taxable transaction, the existence of elements of a taxable transaction that have not been declared or the existence of elements indicating an amount of tax debt that differs from that declared;
- setting up and maintaining tax records;
- information and assistance to the taxpayer.

Organization of tax inspection

Tax inspection activities are structured according to the following types of regional and local offices, in order from smaller to larger geographical jurisdiction:

Provincial inspection offices

These contain the inspection teams/units that perform tax inspections on small taxpayers, be they natural persons or legal entities, within their province.

These units are normally comprised of an inspector (*titulado superior*, graduate with a four- or five-year university degree), supported by a sub-inspector (*titulado de grado medio*, generally a three-year qualification) or by a public tax agent (*bachiller superior*, secondary education completed).

On occasion, these units are directed by an inspector who coordinates the activity of several sub-inspectors (three-year qualification), although the sub-inspectors may only perform a full verification when the total volume of transactions is less than USD 2 million in the case of business activities or USD 200,000 for professional activities.

In the second case, the proceedings are signed by the unit inspector.

Finally, there may occasionally be a unit directed by a sub-inspector at the highest level within his or her occupational category, who coordinates the activity of other sub-inspectors, within the limits indicated in the above paragraph.

Within the provincial inspection office there are, in addition to the inspection units themselves, other services that collaborate in the execution of their duties:

- *The verification and selection service or section*, which is assigned the following functions:
 - analysis, verification and comparison of the information obtained through any means with the information supplied by the taxpayers in their declarations;
 - assessment of the results obtained from these operations as a function of their impact on tax liability;
 - determination by sector or individual of the taxable persons and taxpayers as to whether it is considered necessary to initiate investigation and verification activities.
- *Information service or section* in charge of capturing and collecting data, along with formally serving notice upon those who have not fulfilled their duty of supplying information.
- *Administrative registry*, which has to carry out any tasks and work of an administrative nature in support of the completion of duties assigned to the inspection office.
- *The technical offices* are assigned the duties of issuing reports and statements, performing appraisals and producing economic and tax studies.

Regional inspection offices

These contain the inspection teams/units that perform tax inspections on large taxpayers (volume of over USD 6.7 million), who have their tax domicile in the region.

The regional inspection offices are made up of an inspector and one or two sub-inspectors. The only person authorized to sign the proceedings is the inspector. The sub-inspectors collaborate with the Inspector in verification procedures.

These regional inspection offices are also the base of the regional units for the management of large enterprises mentioned earlier.

Appendix 2

As stated above, it was considered appropriate for the tasks of management and inspection of large taxpayers (volume of over USD 6.7 million) to be carried out in the same regional office. Thus, for units under the same chief, the presentation of declarations submitted by the taxpayer undergoes an initial analysis and, where applicable, an in-depth inspection or audit is performed, which we consider as globally contributing to greater tax control.

The regional inspection offices have the following structure:

- technical office (a unit to assist the chief of the regional office);
- regional inspection area (in which the inspection units are grouped);
- regional unit for the management of large enterprises;
- special judicial assistance units (development of expert opinions and support to judicial bodies).

Units having jurisdiction throughout the national territory

The following bodies, among others, have jurisdiction throughout the national territory:

- National Tax Inspector's Office (*Oficina Nacional de Inspección*).
- National Fraud Investigation Office (*Oficina Nacional de Investigación del Fraude*).

National Tax Inspector's Office

This is the base of the inspection teams that have jurisdiction throughout the national territory and over very large taxpayers.

The Director of the Department of Financial and Tax Inspection is responsible for assigning specific taxpayers to this office, as long as one or more of the following requirements are met:

- their activities are performed in a significant area of the national territory;
- they hold an outstanding position in an economic sector;
- they pay taxes through the Consolidated Taxation Regimen (*Régimen de Tributación Consolidada*);
- the transactions that they perform are of special significance or complexity on a national scale;
- they are linked to other taxpayers already assigned to the office.

The jurisdiction of the National Tax Inspector's Office may also comprise tax obligations derived from taxable circumstances corresponding to non-resident natural persons or legal entities without a permanent established

domicile in Spain, when, with regard to the said taxable circumstances, the representative, depositor or manager of the non-resident's income is assigned to the office due to tax obligations.

With regard to all of these assigned liable taxpayers, the National Tax Inspector's Office performs verification and investigation activities. Similarly, said office will perform management functions associated with these activities and within the scope of its jurisdiction.

Furthermore, the Director of the Department of Financial and Tax Inspection may also agree to the extension of the jurisdiction of the National Tax Inspector's Office to carry out inspection activities as follows:

- in relation to taxpayers who show evidence of possible fraud which, due to exceptional seriousness, complexity or apparent establishment within the territory, must be investigated
- verification or investigation activities related to other liable taxpayers, as long as there are sufficient grounds to justify them;
- verification or investigation of liable taxpayers who display common characteristics as a function of activities carried out, insofar as said taxpayers are not assigned permanently.

The verification and investigation activities assigned to the National Tax Inspector's Office are carried out by inspection teams (*equipos de inspección*).

The verification and investigation activities assigned to the National Tax Inspector's Office shall be directed and controlled by the chiefs of the said teams, who shall assume responsibility for these activities.

The teams shall be comprised of the team chief, along with inspectors and sub-inspectors assigned to them. A typical team may be made up of three inspectors and four sub-inspectors.

The inspection teams shall also include *Hacienda Pública* (the Spanish equivalent of the Inland Revenue Service) agents as required by the team to carry out its duties.

The Inspection Teams are basically defined as being totally or mainly associated with a specific economic sector and are grouped by function relative to one or several economic sectors under the directorship and

Appendix 2

coordination of an assistant chief inspector to the chief of the National Tax Inspector's Office.

The structure of the National Tax Inspector's Office is:

- inspection area (where the inspection teams are grouped);
- central unit for the management of large enterprises;
- technical office (steering unit).

National Fraud Investigation Office (*Oficina Nacional de Investigación del Fraude*)

The National Fraud Investigation Office is assigned the following duties:

- the study of tax fraud and the adoption of initiatives to formulate general strategies to combat it;
- the study and analysis of procedures for combating fraud, as used by other tax authorities, as well as the relationship between government bodies and equivalent units from countries within our economic and business environment;
- performing economic studies and studies by sector;
- the establishment of tax investigation and verification methods, along with the creation of “inspection manuals”;
- directly obtaining or coordinating activities for obtaining domestic and international information, along with the design of data-gathering strategies;
- directly performing or coordinating verification and investigation activities specifically authorized by the department director;
- promoting and coordinating investigation activities and techniques to be carried out by central and regional tax services;
- informing on the effect that legislative modifications may have on types of fraud, as well as on control mechanisms.

The Director of the Department of Financial and Tax Inspection may agree, through a resolution and following a proposal by the chief of the National Fraud Investigation Office, that certain liable taxpayers have been assigned to the National Fraud Investigation Office, for the purposes of verification and investigation activities.

The activities necessary for the execution of duties are carried out by the teams making up the structure of this office. The teams are made up of a team chief, along with other inspectors and sub-inspectors assigned to him. The duties attributed to the National Fraud Investigation Office will be carried out by the following teams:

-
- *Team for the study of tax fraud*, charged with performing studies and developing proposals for strategies to combat fraud, along with measures to encourage voluntary compliance with tax obligations, according to indicators of tax fraud in Spain and their constraints, performing economic studies and studies by sector regarding economic activities, and developing systems for the assessment of tax risk according to economic sectors or types of fraud.
 - *Team for control methods and procedures*, charged with creating and establishing methods and procedures for tax investigation and verification, along with minimum content or compulsory content for specific inspection activities, the creation of “inspection manuals”, and the design of strategies for the improvement of procedures and criteria for selecting taxpayers for inspection.
 - *Central information team*, charged with gathering relevant data for combating tax fraud, channelling the exchange of information with other state-wide, supranational or foreign government bodies, the study of alternative or indexed sources of information for investigation and verification of tax fraud, the analysis and study of data-gathering strategies, along with the exchange of information to support the said investigation and verification duties, designing and coordinating data-gathering campaigns to be carried out by inspection services, along with collaborating in these areas with other departments of the Agency, verification of compliance by any persons or entities with the obligation to supply data or background information resulting from their relationship with other persons, when required in general.
 - *Central fraud investigation teams*, charged with the duties of designing, coordinating, and, where applicable, execution of tax fraud investigation projects of specific types, the formulation of proposed measures and criteria for the development of inspection plans resulting from investigations performed, the coordination of selection and tax verification activities derived from the development of an investigation project when carried out by other inspection services, and finally the development of verification and investigation activities specifically assigned to them by the chief of the National Fraud Investigation Office.

Basic organic structure of the Financial and Tax Inspection Department
(*Departamento de Inspección Financiera y Tributaria*)

The Financial and Tax Inspection Department is the body which has traditionally been assigned the duties of verification, control and prevention of tax fraud.

Appendix 2

This department has the following duties ascribed to it:

- the management, planning and coordination of tax inspections, except in the cases of taxes corresponding to other departments;
- the study, design and programming of tax inspection activities and procedures, as well as the escalation of proposals for the modification of regulations to the corresponding administrative centres;
- the study, design and programming of tax collection management relative to the inspection units that have been assigned this duty;
- the performance of inspection activities through central bodies integrated into the department;
- the creation of informational and statistical systems regarding the results of activities by the tax inspection services, with the collaboration of the tax authority's computing department; and
- any other duties ascribed by current legislation.

APPENDIX 3

The Canadian experience: Auditor Recruitment and Apprenticeship Programme (ARAP)¹⁹

Internal recruiting

Internal recruiting is a privileged source of resources familiar with the organization and interested in working in the audit area. The verification function described earlier is a natural career evolution, and audit is strengthened by experienced staff with varied backgrounds (collections, client services, etc.). Furthermore, as the training and development of an auditor progress throughout the years (legislation, audit techniques, soft skills, as well as the specific culture of the Tax Administration), with exposure to progressively more complex files, it becomes increasingly difficult for an outsider to join the ranks at an intermediate or senior audit level in an effective manner, and promotions come almost exclusively from within. However, audit being the largest function, the needs are answered in a very limited way from within, in terms of numbers, and external recruitment is the main source of staffing at the entry level.

External recruiting

Tax administrations should consider the development of a comprehensive, cost-efficient approach to external recruiting and training.

The ARAP is designed to recruit highly motivated university graduates who have the potential to excel as future auditors within the CCRA. The programme offers challenging work assignments in different geographic locations across Canada, combined with specialized training courses in accounting and tax auditing-related fields. This combination of practical work and formal training provides auditors with a unique opportunity to develop their technical accounting and auditing skills over a period of 18 months.

The purpose of the Auditor Recruitment and Apprenticeship Programme is to develop a central pool of highly qualified candidates from which future auditors can be drawn to fill audit jobs within the audit function wherever openings exist. Through this programme, the CCRA wishes not only to

19. This is an over-simplified version of the current ARAP, which is a 15-month programme, including training in both the income tax and the GST (VAT).

Appendix 3

ensure a reserve of highly competent auditors but also to work towards its medium and long-term employment equity objectives.

The 15-month learning plan allows the trainee to have an overall exposure to the Agency by:

- completing audit officer work (individuals' tax returns with business income) as well as an exposure to auditor work (corporations); and
- being assigned to other areas of the Agency, such as collections, enquiries and appeals.

The training covers both technical (i.e. Income Tax Act, audit, computer applications) and soft skills (i.e. communication skills, dispute/conflict resolution, etc.). Tax practitioners and representatives of other professional bodies meet with the recruits to give them the private sector perspective and a view of the Agency from the vantage of a client.

Trainees are evaluated at the end of the sessions to assess their acquired knowledge. Also, they are evaluated throughout the on-the-job assignments in order to assess the application of the following skills:

- analytical thinking;
- decisiveness /judgement;
- effective interactive communication;
- impact and influence;
- initiative;
- relationship/network building;
- stamina/stress management;
- teamwork and cooperation.

The infrastructure to support the trainee, such as the use of coaches, buddies and mentors creates an environment of collaboration and teamwork. This approach encourages the sharing of information, knowledge and experience between the trainees, thereby creating networking opportunities.

Participants are hired as full-time employees appointed to audit developmental positions. However, since hired from outside the public service,²⁰ they are subject to probation during the 18 months of the programme. At the end of the probationary period, the participant's performance is formally evaluated and on an individual basis a decision is made as to whether he/she meets the (professional) auditor level, is re-assigned to an

20. Twelve months for recruits from inside the public service.

audit officer position to complete training or is terminated from employment.

As a major condition of employment during and after the programme, participants should be willing to undertake various training assignments in different Tax Services Offices (TSOs) across Canada. Upon successful completion of the programme, the participant should also be willing to be assigned to any of our local offices across Canada where there is a need to fill vacant auditor positions. However, trainees will normally be appointed within their regions, depending on the number of positions available.

The programme includes three blocks of formal training sessions ranging between 3 and 7 weeks in duration. All sessions are held in a centralized location and cover the necessary audit technical content as well as soft-skills training. The programme also includes customized learning activities for participants who need to improve on specific skills (e.g. analytical skills, communications, negotiating skills, etc.).

A local mentoring and coaching structure supports the programme. Headquarters ensures that local offices have the appropriate number of audit managers and supervisors trained on effective mentoring and coaching techniques.

Appendix 3

ARAP Programme

Formal and on-the-job training

<p><i>Phase 1</i> <i>Audit of individuals' tax returns</i> (7 months)</p>	<p><i>Phase 2</i> <i>Assignments to client services enquiries, collections and appeals</i> (4 months)</p>
<p><i>Structured training</i> (7 weeks)</p> <ul style="list-style-type: none"> – Orientation to the organization – Basic income tax law – Audit skills and techniques – Forms and procedures – Management information systems – Human interaction skills <p><i>Exam</i></p> <p><i>On-the-job training</i> Assignment of files</p> <p>Use of a learning partner: 2 weeks (24 weeks total)</p> <p>Evaluation (on-going during OJT)</p>	<p><i>Structured training</i> (3 weeks)</p> <ul style="list-style-type: none"> – Collections overview, techniques and tools – Enquiries training, enhanced communications skills – Appeals overview, fairness provisions, voluntary disclosure <p><i>Exam</i></p> <p><i>On-the-job training</i> Assignments to collections (4 weeks), enquiries (6 weeks), and appeals (2 weeks)</p> <p>Use of a learning partner: 2 weeks (15 weeks)</p> <p>Evaluation (on-going during OJT)</p>
<p><i>Phase 3</i> <i>Audit of corporations' tax returns</i> (4 months)</p>	
<p><i>Structured training</i> (5 weeks)</p> <ul style="list-style-type: none"> – Tax law, additional rules – Corporation and their shareholders – Shareholders debts – Related corporations – Audit techniques <p><i>Exam</i></p> <p><i>On-the-job training</i> Assignment of restricted corporation audits using coaches (13 weeks)</p> <p>Evaluation (on-going during OJT)</p>	

APPENDIX 4

In this Appendix, a typical generalized and simplified training profile is provided covering the wide range from verification officer to auditor with the largest enterprises. The example is derived from the Canadian Tax Administration.

Training profile: Office examination officer

Week	Subject	Duration (days)	OJT/Activity
1	– Orientation for officers	1	
	– Introduction/structure of the Income Tax Act	2	
	– Income and expenses basic rules	2	
2	– Income and expenses basic rules	5	
3	– Capital cost allowance	5	
4	– Capital gains general rules	2	
	– Use of property rules	2	
	– Computerized inform. system	1	
5	– Automobile expenses	2	Low complexity level files are worked on during this course
	– Conducting an office examination	3	
6	– Conducting an office examination	5	Low complexity level files are worked on during this course
7	– Access to information (database) system	2	General overview using technical manual
	– Various Word, Excel, Explorer and Outlook courses if required		
	or On-the-job training	3	Combination of low complexity level files and review of selected areas of the office examination online manual

Appendix 4

Week	Subject	Duration (days)	OJT/Activity
8	– Various Word, Excel, Explorer and Outlook courses if required or On-the-job training	3	Combination of low complexity level PM2 files and review of selected areas of the office examination online manual
	– Basic interviewing skills workshop	2	
9-25	– On-the-job training		Combination of files with progressive complexity
26-52	– On-the-job training		Combination of files with progressive complexity
	– Eligible capital property	1	
	– Settlement of debt/collections	1	
	– Reasonable expectation of profit	2	
	– Current year losses and losses carried forward	2	
	– Penalty provisions	2	
	– Self-employed revenue	3	
	– General partnership rules	2	
	– Specialized communication skills	2	

Training profile: Audits of individuals' tax returns (small business audit division)

Course	Mode	Duration (days)	Comments
1. Orientation	Class	3	For new employees only
2. Tax introduction Part 1	S-S	3	
Tax introduction Part 2	Class	10	
3. Review of files	OJT	4	Supervised by a group head
4. Audit introduction			
– investigative approach to field audit	Class	4	
– field audit techniques	Class	10	
– forms and procedures	Class	4	

Appendix 4

Course	Mode	Duration (days)	Comments
5. Management inform. system	Class	3	
6. Effective communication	Class	1	
7. On-the-job training Part 1	OJT	60	Supervised by group head Assistance to experienced auditor on individuals' tax return assignment of own files (low complexity)
8. Indirect verification of income	Class	5	Net worth, 3rd party, etc.
9. Interviewing skills workshop	Class	3	
10. On-the-job training Part 2	OJT	60	Increasing file complexity with high net worth possibility
11. Losses flowchart	Class	2	
12. Fraud detection	Class	2	
13. Tax avoidance	Class	1	
Optional			
1. Current amendments	S-S	Variable	On-going basis, following legislative amendments
2. Partnership	Class	5	
3. Estate and trust	Class	5	
4. Research guide and tax analysis	S-S	Variable	
5. Information sessions			
– new policies and procedures	Sem.	Variable	Review of significant changes
– technical update	Sem.	Variable	Review of new instructions and publications
6. Stress management	Class	1	
7. Business writing		2	
8. Specific audit techniques (farming, fishing, etc.)	S-S	Variable	

Appendix 4

Notes on the training profiles:

Mode:

Class: Refers to formal classroom setting.

S-S: Self-study material.

OTJ: On-the-job training (and coaching).

Sem.: Seminar.

Optional course: Means that the incumbent should take the course as and when it addresses the specific needs of a particular workload, and the sequence is not a determining factor.

Technical information sessions and current amendments seminars are an integral part of an auditor's training curriculum. These sessions are included in the training profiles to re-enforce the importance of such vehicles to communicate timely information relevant to effective audit operations. Their form varies from structured presentations at the national level to very informal round-table discussions at the local level, the timeliness and availability of technical expertise being the determining factors.

Training profile: Audits of corporate tax returns (small business audit division)

Course	Mode	Duration (days)	Comments
1. Intermediate tax law	Class	10	
2. Related persons and associated corporations	Class	2	Including flowcharting
3. Intermediate audit techniques	Class	10	
4. Corporate estate and trust	Class	8	
5. Charities – Legal concepts and audit techniques	Class	3	

Training profile: Audits of corporate tax returns (medium-size business audit division)

Course	Mode	Duration (days)	Comments
1. Audit of computerized accounting systems	Class	5	Use of retrieval audit package (IDEA)
Advanced tax courses			
2. Corporate reorganization	Class	5	

Course	Mode	Duration (days)	Comments
3. International transactions	Class	3	
4. (International) non-arm's length transfer pricing	Class	5	
5. Amalgamations and wind-ups	Class	3	
6. Debt financing	Class	2	
Advanced audit techniques			
7. Foreign income and affiliates	Class	3	
8. Capital markets	Class	3	
9. Economics of transfer pricing	Class	3	
Optional			
10. Industry specialization: banking, insurance concepts, oil and gas, mining, etc.	Class	Variable	Led by industry specialists

*Training profile account executive: audits of corporate tax returns
(large-size business audit)*

Account executives are very experienced and technically competent auditors that have access to experts in the various fields of the organization. Some of them will have worked in one or more special areas throughout their career (international, tax avoidance, investigations, EDP, valuation, etc.) and hence have received advanced technical training in such areas.

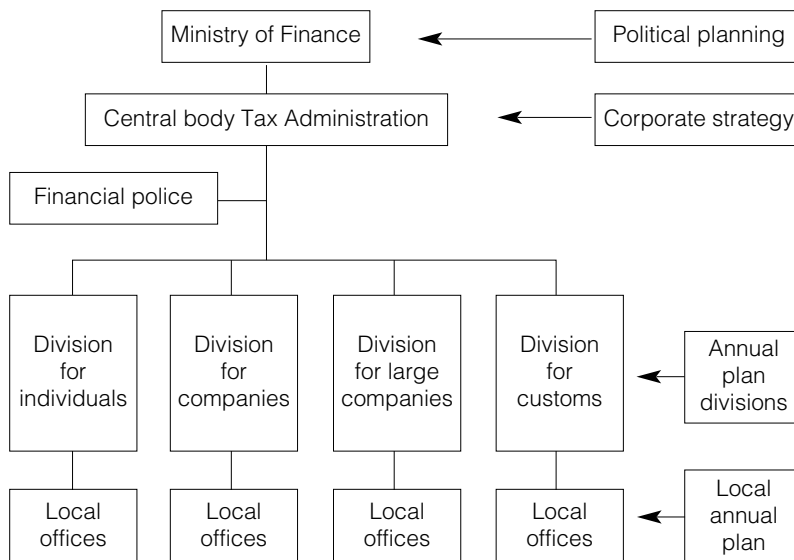
Formal training at this stage is centred around management and soft skills such as team building, coaching and mentoring, dispute resolution, and advance communication. They maintain their technical expertise and stay on top of emerging issues by participating in various industry workshops, periodic information sessions by specialized areas, interacting with colleagues in seminars, and attending external conferences.

APPENDIX 5

To demonstrate the cycle of annual plans, the following chart of a client-oriented organization is taken from page 58 of the *Handbook for Tax Administrations – Organizational Structure and Management of Tax Administration* (2000); the planning functions at the various levels within the organization are added to the chart.

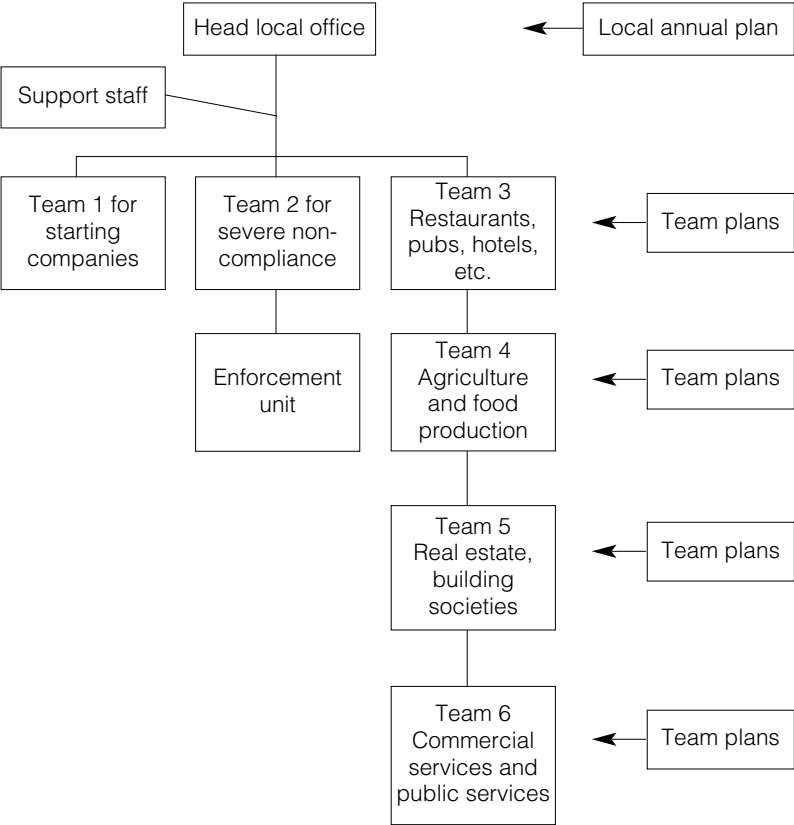
Which use of the planning and control system is made will partly depend upon the way in which the administration is managed as a whole, i.e. whether it is centralized or decentralized.

Chart of a client-oriented organizational structure: from ministry to local offices



Appendix 5

From local offices to teams:



APPENDIX 6

TYPOLOGY OF BUSINESSES

Classification					
Organizations producing for the market	With a dominant flow of own goods	Trade	Delivering mainly to other industries		Examples
			Delivering mainly to final consumers		Shops, retailers
			Industrial organizations	Homogeneous mass production	Flowingly rotating
				Intermittently parcellized	Brick works, breweries, tanneries, wire-drawing mills
		Heterogeneous mass production		Singular	Glass-works, potteries, wall-paper factories, preserving factories
				Composite	Factories for shoes, clothing, bicycles, cars, etc.
		Made-to-order production		Serial	Serial shipbuilding, serial construction works
			Unique	Shipyards, construction works	
			Agriculture		Agriculture, forestry, fishing
		Extractive organizations		Mining, oil exploitation	

Appendix 6

Classification		Examples		
Organizations producing for the market	Without a dominant flow of own goods	Service organizations	Service with a certain flow of goods	Flow of goods, owned by the organization
				Flow of goods, owned by third parties
				Delivery of goods or services via supply networks
		Other services	Service, offering space-time capacity	Specific reservation
				No specific reservation (use of tickets)
Organizations without mediation of the market	Without a dominant flow of own goods	Financial institutions	Other services	Renting, storehouses, hotels, hospitals, aviation
				Theatres, entertainment providers, trains, buses, taxi-cabs
				Cleaning, medical professions, lawyers, auditors, barbers, etc.
				General banks, saving banks, mortgage banks
				Venture capital companies, investment companies
				Stockbrokers
				Life insurance, indemnity insurance
Organizations without mediation of the market	Without a dominant flow of own goods	Private organizations	Insurance companies	Government (national, provincial, municipal), public services like police, fire-brigade
				Foundations, welfare, religious organizations

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