

# **Tax Administrations and Small and Medium Enterprises (SMEs) in Developing Countries**

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## **Foreword**

This paper is primarily based on my personal experiences over the last eleven years as an international tax administration consultant. I have served as a resident tax administration advisor in five developing countries in Eastern Europe and the Middle East; as the first operational director of the Kosovo Tax Administration; and, as a short term advisor in seven other developing countries. Prior to my international work, I spent 30 years as an official of the U.S. Internal Revenue Service, most of which was at the senior management level. A number of technical facets of tax administration addressed in this paper have been covered elsewhere in greater detail. I have attempted reduce a large amount of information to a manageable size so as not to lose the attention of the target audience of non-tax administration professionals. However, I have provided additional source material and references in the annexes to this paper, should the reader wish to delve further in the field of tax administration.

## **Section I**

### **I Background and Introduction**

1. A country's tax administration is one of the few public sector organizations which touches the lives of a country's citizens and businesses on a daily basis and, arguably has the greatest impact on their livelihood. Tax administration employees are amongst the most frequently contacted government officials and often represent to the public what is right or wrong about their government. The responsiveness, integrity, and quality of tax administration staff must therefore meet a very high standard. Revenue collected from taxes along with customs collections represents the major funding source for governmental expenditures. An effective and efficient tax administration system is integral to any country's well being. The proper amount of tax must be collected in a timely manner and the enforcement powers of the tax administration must be applied judiciously and in an even handed fashion. The tax administration must provide an even playing field for business by ensuring that all taxpayers meet their tax filing and paying requirements. This requires significant efforts to deal with the underground economy and to, therefore, increase the tax base. Failure to bring business activity from the shadow economy into the tax system puts compliant taxpayers at a competitive disadvantage, and ultimately leads to an erosion of the tax base. The tax administration must balance its educational and assistance role with its enforcement role. The overriding goal is to foster voluntary compliance with the tax laws. This represents a significant challenge in a developing economy.

2. Private enterprises in developing countries often face difficulties when dealing with the government in general and the tax administration in particular. Many of the difficulties with the tax authorities are the consequence of poorly conceived tax policies and a lack of certainty regarding future policy changes. It would be rare indeed to not hear complaints about the complexity and/or ambiguity of the tax laws, high tax rates, and the lack of an integrated fiscal strategy that takes social taxes, and local taxes and fees into account when determining the overall tax burden placed on the business community.

3. In carrying out their responsibilities, tax administrations can also create problems for the business community when they impose burdensome reporting and record keeping requirements; conduct excessive inspections and audits; fail to deal with corrupt tax administration employees; and, fail to provide transparency in tax administration operations. This type of environment harms individual businesses and the overall economy. As a result, many in the business community react by taking steps which adversely affect the tax base. This typically includes underreporting profits and turnover; underreporting employee wages; and, by creating "phantom" employees. A significant number of businesses also fail to register or file tax declarations. This only increases the burden on those taxpayers who try to comply with the tax law, and discourages their future compliance. The result is a vicious cycle which tends to preserve the status quo. Only meaningful reforms to the tax system can break the cycle and result in an improved business climate which will stimulate economic growth.

4. This document is intended for use by staff of the International Finance Corporation of the World Bank. It provides information and tools: to gauge the state of development of a country's tax administration; to serve as a primer on tax administration organizational structure and operations; and, to describe best practices of modern tax administrations. It, also, contains concrete examples of how a tax administration can facilitate the growth of small and medium enterprises (SMEs) by eliminating administrative and other burdens faced by these enterprises in developing countries.

5. Sometimes the line between tax policy and tax administration is blurred. For this reason this document contains some tax policy options that have been used to promote the growth of small and medium enterprises, but will primarily focus on tax administration reform.

## Section II

### II. Characteristics of Tax Administrations in Developing Countries Prior to Reform

6. Most or all of the following characteristics are present in countries before tax administrations undergo major reforms. This is especially true in a country which is transitioning from a command economy to a market-driven economy.

- ❖ All registered taxpayers and all tax liabilities are “controlled” on a regular basis. The reliance is on the known universe of taxpayers who are subjected to frequent and intrusive tax inspections regardless of their past compliance history or loss of revenue risk they may pose. Little attention is paid to identifying non-filers and bringing them onto the tax rolls. This is especially true with taxpayers operating in the illegal, as opposed to the formal sector.
- ❖ Most tax controls or inspections do not represent thorough or professional financial audits practiced by modern tax administrations and do not meet international standards.
- ❖ There is no limit on the total amounts of penalties that can be assessed in addition to tax. The actual amount of tax due may be substantially less than the penalties assessed.
- ❖ There is limited interest in building a system of self-assessment and voluntary compliance with the tax laws. A PAYE (pay as you earn-employee taxes withheld by an employer which are required to be deposited in the tax administration’s account on a periodic basis) system may not be in place and there is limited withholding at the source by banks or other third part payers (interest, dividends, etc.).
- ❖ There is a lack of specialization in the tax administration. Prior to a tax return being accepted for filing, a tax inspector pre-reviews the tax return for “accuracy” and may provide “advice” to the taxpayer. The same tax inspector may then “assess” the tax liability, subsequently be responsible for collection of any unpaid amount, and even determine if a control visit is necessary. This close relationship where the tax inspector is responsible for a specific group of taxpayers can easily lead to corruption.
- ❖ The emphasis of the tax administration is to meet a pre-determined revenue target for which they have limited or no input.
- ❖ There is a significant “underground” or “grey” economy with a high percentage of unregistered and/or non-filing taxpayers as well as filers who underreport their income, turnover, or profits.
- ❖ There are inadequate controls to prevent external or internal corruption.

- ❖ There are little or no written operating procedures to be followed by tax administration staff either in the same tax office or in different tax office locations.
- ❖ Taxpayer education and assistance efforts are minimal. There is a limited effort to solicit business or trade association input on tax administration requirements or operations.
- ❖ Tax administration internal communications are minimal and/or there is a top down management approach which discourages employee suggestions or feedback. Overall management practices are poor.
- ❖ Training is considered an overhead activity which does not justify much attention or resources. There are few or no training professionals on staff. The emphasis of staff training is on teaching the contents of tax laws as opposed to applying the laws. Little or no attention is paid to skills, techniques, procedures, customer relations, or managerial training.
- ❖ There is little interest in improving the overall image of the tax administration. Proper treatment of taxpayers and protection of taxpayer rights is not a major concern.
- ❖ There is limited use of computers. The emphasis is on the acquisition of hardware as opposed to the development of an overall information system plan. Software development is based on automating current operations as opposed to reengineering the business processes of the tax administration to produce maximum effectiveness and efficiency.
- ❖ There is no centralized or unique numbering system used to identify all taxpayers. Therefore, the establishment of a taxpayer master file for the country is impaired. There may also be different numbering schemes used by other government bodies such as business registration, customs service, social taxes, etc. for the same taxpayer. These multiple systems impair the tax administration's ability to obtain and match information on business taxpayers.
- ❖ Taxpayers may be faced with multiple and uncoordinated audits and/or controls from different organizational elements of the tax administration. They may, also, face audits by the social insurance agencies that collect their own "contributions" or taxes which are not coordinated with the tax administration.
- ❖ The number of employees and/or skill sets of tax administration staff are not in balance with organizational requirements.
- ❖ The number and location of tax administration offices are not in balance with organizational requirements.

- ❖ Written position descriptions and periodic written employee evaluations based on job knowledge, skills, attributes, and overall job performance are minimal. There is no formal merit promotion system. Staff salaries are inadequate to meet normal living costs. Employees may receive additional funds solely on the basis of taxes assessed and/or collected as opposed to the validity of assessment/collections or qualitative performance measures.
- ❖ Because top level tax administration management focuses on short-term results over medium to long-term reforms, a strategic business plan has not been developed or implemented.
- ❖ There is an inadequate focus on large taxpayers and prioritization may not be placed on the collection of major national taxes such as income tax or VAT.
- ❖ With the exception of monitoring progress in meeting revenue collection targets, the central office of the tax administration may only exercise limited control over local tax office operations.
- ❖ Political influence is often pronounced and damaging and may adversely impact both the outcome of tax case work and the selection and promotion of staff at all organizational levels.
- ❖ Coordination between the tax administration and other government bodies, including the customs service, is ineffective. Turf battles over both operations and data are common.
- ❖ The focus on inspection and control activities leaves little resources to concentrate on collection of unpaid tax liabilities. Delinquent tax liabilities are large and may include a number of state-owned enterprises.
- ❖ Enforced collection of delinquent taxes is not aggressively pursued. Where a system of secured transactions has not been established and title to land is uncertain, the tax administration is also hampered in taking seizure and sale actions.

7. The above listed characteristics are barriers which must be overcome not only to engender reform in the tax administration but also, to provide better conditions for the growth of the private sector. For example, a system of secured transactions is more important for the banking, investment and development sectors than it is to the tax administration. Transparency of tax administration operations provides valuable information to assist private sector business planning and operations by knowing what to expect under various scenarios. Effective tax administration operations result in timely responses to taxpayer inquiries, processing of tax refunds and resolution of problems and disputes.

## **Section III**

### **III. Tax Administration/Business Interface**

8. There are a number of points of contact between the taxpayer and the tax administration. I will list them in terms of the frequency of contact.
9. The initial contact between the business taxpayer and the tax administration usually occurs when registering to secure a taxpayer identification number. Registration is a pre-requisite to conducting business operations. However, the taxpayer may first contact the tax administration to secure information about tax filing and paying requirements. Follow-up contacts may be made to request additional information or tax forms, publications, or assistance. Assistance may be requested to check on the status of the taxpayer's account including VAT refund inquiries.
10. If the taxpayer has not provided all the information requested on the tax return, or if there is a mathematical or other error on the return, there will be a follow-up contact by the tax administration.
11. If the information provided on the tax return does not match other information in the tax administration's files that it is cross-checked against, the taxpayer will be contacted.
12. If the taxpayer is selected for an audit or control, the taxpayer will be contacted. The percentage of taxpayers audited is dependent on the status of the tax administration's development and resource availability.
13. If the taxpayer disputes the results of a tax audit, there will be contact in an attempt to resolve the dispute. The percentage of cases that are appealed is dependent on the status of the tax administration's development and the clarity of tax legislation.
14. If the taxpayer fails to timely pay the required amount of tax due, or fails to file a required return, a contact will result. The percentage of taxpayers delinquent in filing and/or paying their taxes is dependent on the status of the tax administration's development as well as economic, social, and cultural conditions. If the taxpayer is suspected of criminal tax violations, there will be contact by the tax administration. Normally only a very small percentage of taxpayers will be the subject of such contacts.
15. The contacts between the tax administration and taxpayers reflect the major activities or business processes which the tax administration performs.

## Section IV

### IV Tax Administration Business Processes

15. Modern tax administrations all perform common types of activities or business processes. Some of these activities (core business practices) directly relate to the mission of the tax administration while other activities provide the support framework to properly carry out this mission. Core business processes are interrelated and ongoing communications and coordination between these processes is essential. For example significantly increasing the number of audits in a given year will impact taxpayer services and enforced collection resource requirements. Similarly, increased attention to non-filers will impact audit and collection resource needs. Legislative changes will have similar impacts. Therefore, the integration of all these factors into the development of an annual operating plan for the tax administration becomes a complex and demanding task. All these common business processes are represented in the tax administration's organization chart. However, even within a functionally structured organization the design and substructure of these blocks vary. A modern tax administration system is based on the establishment of a unique taxpayer identifying number (TIN) which is the foundation of its management information system and which monitors the status and movement of taxpayer cases through all core business processes.

#### ❖ *Taxpayer Assistance, Registration, and Education*

16. This business process provides taxpayer information and educational services and includes the following activities:

- Registering taxpayers
- Assigning a unique taxpayer identification number (TIN)
- Maintaining and updating taxpayer registers
- Contact point for taxpayers who visit, call, or write (including internet) to the tax administration.
- Providing and staffing taxpayer service counters and call-in operations
- Responding to general inquiries regarding registration, filing or payment requirements and basic tax law, as well as the status of a taxpayer's account, and ensuring that the taxpayer is routed to other areas as appropriate
- Providing tax returns, instructions, and informational publications.
- Developing informational and educational publications
- Conducting seminars on changes to tax laws and procedures for targeted business audiences
- Developing press releases, press conferences and conducting media relations activities to communicate tax administration messages to the general public
- Monitoring subjects of queries to determine the need for additional educational materials for taxpayers, internal tax administration training, and/or internal operational changes.
- Developing and maintaining the content of the tax administration Website

**❖ *Receipt and Processing of Tax Payments, Tax Returns, Information Documents and Revenue Accounting***

17. This business process involves “back office” activities and includes:
- Processing payments received directly from taxpayers or electronically from banks or other third party sources
  - Processing and perfecting tax returns and information documents received from taxpayers and third parties
  - Entering tax return and related data into tax administration databases
  - Matching of taxpayer and third party documents and data
  - Matching of taxpayer filing requirements against received returns
  - Issuance of non-filer and stop-filer notices to taxpayers
  - Matching of tax payments, credits, and debits against tax assessments
  - Issuance of balance due notices to taxpayers
  - Issuance of tax refunds
  - Maintaining, updating, and providing revenue accounting data

**❖ *Audit/Control***

18. This compliance business process encompasses all taxpayer audit/inspection/control operations
- Develops the tax administration’s audit plan
  - Audit case selection including development and application of risk analysis programs
  - Conducting and managing both field and office audits for all types of taxes (Income, VAT, etc.) and contributions (social security, health, unemployment, etc) administered by the tax administration.
  - Examination of tax returns, books, records, invoices, and related financial data
  - Investigation of taxpayer sources of income, assets, and third party sources and data
  - Preparation of tax returns on behalf of the tax administration where the taxpayer fails to voluntarily file.
  - Issuance of written audit reports and determinations which can result in additional tax, penalty, and interest liabilities; tax refunds; or no changes in tax liability
  - Analysis and application of tax laws and regulations to the facts of a case under audit.
  - Quality review of audits

**❖ *Appeals***

19. This process provides an independent administrative review upon request of a taxpayer who disputes the results of determinations made by the audit functions.
- Conducts administrative hearings to review case determinations by audit staff.

- Issues written determinations which can uphold or modify audit results.
- Where applicable, may also conduct hearing on decisions made in the enforced collection function.

❖ ***Collection of Delinquent Accounts/Enforced Collection***

20. This process deals the actions the tax administration takes when the taxpayer fails to pay a tax liability based on either a self-assessed tax return or an assessment resulting from audit activities.

- Contacting taxpayers and requesting payment of all delinquent and current taxes that are due.
- Interviewing taxpayers and third parties to secure information regarding sources of income and assets
- Reviewing taxpayer financial records and third party data to determine the taxpayers ability to pay delinquent taxes
- Determining the reason for non-payment
- Determining if the taxpayer should be granted additional time to pay a tax liability based on financial analysis and granting installment payment privileges where applicable
- Determining if a tax liability is collectible
- Conducting investigations to locate taxpayers and/or taxpayer assets
- Identifying assets of the taxpayer that can be attached or seized for non-payment of taxes due
- Taking enforced collection actions when taxpayer refuses to pay voluntarily
- Issuing attachment orders to banks to freeze and/or seize taxpayer accounts
- Issuing attachment orders to third parties to secure funds due to the taxpayer
- Conducting seizures of tangible assets as permitted by law (e.g., real property, machinery and equipment, motor vehicles, etc.)
- Conducting public auction sales of taxpayer assets as permitted by law

❖ ***Non-filer/Stop-filer Operations***

21. This process deals with the actions the tax administration takes when a taxpayer fails to file required tax returns on a timely basis.

- Contacting taxpayers to request filing of all required returns as well as payment of any amounts due.
- Interviewing taxpayers and third parties to secure information regarding taxpayer's filing requirements
- Determining the reasons for non-filing
- Securing delinquent tax returns and all amounts due
- Securing necessary books, records, and other information to enable the tax administration to prepare the taxpayer's return if the taxpayer refuses to voluntarily file

❖ ***Tax Fraud/Criminal Investigations***

22. This business process involves determinations of criminal violations of tax related laws

- Information gathering activities to determine criminal tax law violations
- Investigation of tax fraud and related crimes based on information provided by audit, collection, or other tax administration functions.
- Criminal tax investigations based on information received from third parties including other government agencies
- Recommendations for prosecution for tax crimes

❖ ***Internal Audit/Internal Security***

23. This business process relates to ensuring the integrity of tax administration operating procedures and staff

- Conducts independent reviews to determine the adequacy of and adherence to tax administration internal controls
- Conducts internal audits of all other tax administrations operations
- Conducts investigations of employee corruption and misconduct and attempts to bribe tax administration employees
- Refers cases for criminal prosecution

❖ ***Information Systems Support and Management***

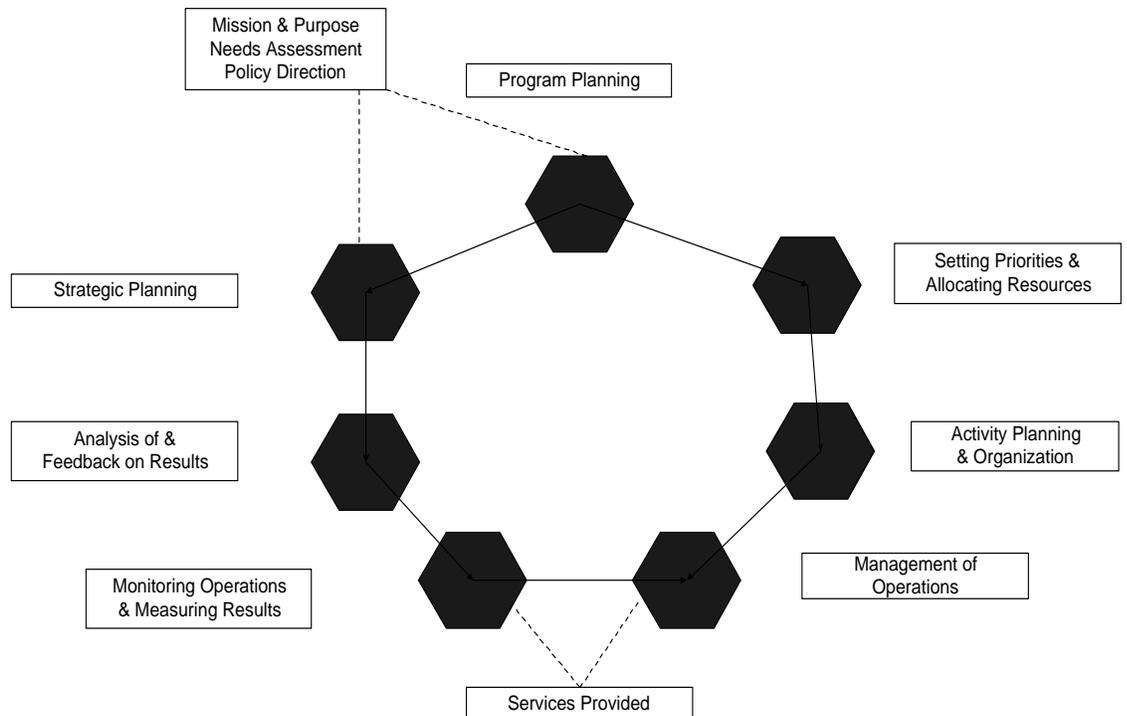
24. This business process involves the development of and updating of the tax administration's Information Systems Plan as well as all hardware and software support services

- In conjunction with operating functions, determines computer and communications hardware requirements to support tax administration operations
- In conjunction with operating departments develops computer software applications necessary to support operating functions including management information reports
- Manages tax administration systems and databases
- Maintains computer hardware
- Maintain the confidentiality, integrity, and security of the database of taxpayer information;
- Ensure the security of the data during transmission to and from the offices as it is passed over the communications network;
- Safeguard the information from unauthorized users, accesses, and tampering;
- Provide technical support for the tax administration's web site
- Support electronic filing capabilities and other electronic data exchange with external sources
- Develops management information reporting systems and provides reports to other business processes.

### ❖ *Planning and Analysis*

25. This business process guides the future development and improvement of tax administration operations as well as current operations
- Development of strategic goals and objectives.
  - Integration of annual business plans for each operating and other support function
  - Setting priorities and allocating resources
  - Analyzing and reporting operational results against plan objectives
  - Developing performance measures
  - Conducting environmental scans to determine how technological, demographic, economic, sociological, political and other trends will impact tax administration operations
  - Conducting studies and tests to improve tax administration procedures
  - Conducting compliance research to improve risk management programs
  - Developing implementation plans for major operational changes
  - Develop legislative implementation plans
  - Obtaining feedback from internal and external stakeholders
26. One approach that applies these activities in a systemic fashion is receiving increasing interest in many governments as well as in the private sector. It is called *Managing for Results*. The managing for results process is a comprehensive approach to focusing an organization on its mission, goals, and objectives. It establishes the accomplishment of those goals and objectives as the primary endeavor for the organization and provides a systematic method for carrying out the endeavor. It requires the establishment of performance measures and the use and reporting of those measures so that everyone can fairly and fully evaluate the outcomes.
27. These activities are depicted in the following diagram and represent a continuing process. It is suggested that the planning and analysis activities of a tax administration follow this process.

# A Managing for Results Process Approach for the Tax Administration



## ❖ *Administrative Services and Support*

28. This process involves personnel management, training, fiscal management, facilities management and other administrative support services to all other operations of the tax administration

- Develops and manages position classification, performance evaluation, recruitment, promotion, labor relations and other personnel programs
- Manages the vetting process for new employees
- Develops and manages training development and delivery programs
- Develops the tax administration budget and monitors budget execution
- Procures all necessary goods and services to support tax administration operations
- Manages and maintains tax administration facilities, motor vehicles, equipment and supplies
- Provides and manages physical and document security

- Develops a code of conduct for tax administration employees
- Provides or arranges interpreter services
- Provides other administrative support services as required

❖ ***Legislative and Stakeholder Relations***

29. This process involves two way communications with stakeholders which significantly impact tax administration operations.

- Maintain liaison with the Ministry of Finance and legislature to get early notice of proposed changes to tax legislation in order to assess impact on tax administration operations
- Propose tax legislation to improve compliance and/or reduce the burden on both taxpayers and the tax administration
- Consult with business and trade associations on a regular basis
- Maintains liaison with international tax administration organizations.

❖ ***Legal Services/Technical Rulings***

30. This process provides legal support services to the tax administration and assistance in interpreting laws and regulations

- Provides general legal services to represent the tax administration in non-tax matters (.e.g. contractual disputes regarding purchase of goods and services)
- Represents the tax administration on tax disputes that are appealed to the courts
- Protects the tax administration's interest in taxpayer bankruptcy and insolvency proceedings
- Represents the tax administration in court where other judicial intervention is required (e.g. suits to reduce a tax liability to judgment, suits to enforce a summons by the tax administration to produce books and records, etc.)
- Provides interpretations on the meaning of tax laws and regulations
- Issues technical public and/or private rulings on the application of tax laws to specific circumstances on which taxpayers can rely prior to filing their tax return
- Conducts tax treaty negotiations and manages exchange of information programs with other government agencies and foreign countries.

## Section V

### V. Core Business Operations and Support Operations

31. Core business operations reflect the purposes for which the tax administration exists. These are: providing taxpayer services; processing tax returns and tax payments; collecting delinquent accounts; securing delinquent tax returns; processing administrative appeals; and conducting tax fraud investigations. All other business processes or activities, though absolutely essential, are conducted to support these core business activities.

32. All core operating processes involve some common activities in the headquarters office of the tax administration with regard to their specific process. These include

- Developing and maintaining policies, operating procedures, and techniques
- Conducting reviews of field office operations
- Providing expertise to the training staff of the Administrative Department in the development of technical training
- Providing expertise to the personnel staff of the Administrative Department in developing job descriptions and work standards.
- Developing the annual work plan for their activities
- Evaluating results in field offices against the work plan
- Providing recommendations on resource requirements to the fiscal staff of the Administrative Department
- Providing business process applications and information management requirement to the Information Systems Department
- Providing legislative recommendations to the legal affairs department
- Providing input for the Corporate Strategic Business Plan

33. In a modern tax administration a relatively small number of taxpayers pursue administrative appeals or are the subject of tax fraud investigations. The laws and traditions of some OECD countries even require that these activities take place outside the tax administration. I've attempted to diagram the workflow of the high volume core business processes below. These are generic and nature and are only provided for illustrative purposes. Optimal workflow diagrams for a specific country can only be developed using the business process reengineering techniques described below.

34. Designated employees of each core operating business process can access data in a case calendar (a segment of the overall information management system) in accordance with their specific security profile. They are required to update the case calendars to document activities regarding a taxpayer case. These case calendars contain the current status of all accounts on which activity is taking place. For example, cases transferred for enforced collection follow-up after returns processing and revenue accounting activities because there is a balance due condition, are moved to the enforced collection database. Enforced collection staff can access this database through the case calendar to determine the tax office and name of the employee to whom the case is assigned. Case actions can also be reviewed. The case calendar is updated when payments are received; payment

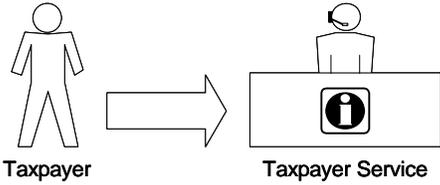
arrangements are agreed; or the case is closed. Similar activity occurs in other core business processes in regard to their operations. These databases are integrated so that the status of any case in the tax administration can be determined by staff with proper access requirements. For example, taxpayer service staff can access all information about the taxpayer's filing, payment, and refund status. This is necessary as many taxpayer inquiries involve the status of their refund, payment, audit, etc. Another feature of the case calendar permits staff of all functions to request the computer system to issue correspondence. For example the audit department can request that an appointment letter is sent and the system will ensure that the appropriate taxpayer data is inserted in the proper letter format. The enforced collection department can request that a final notice is sent to the taxpayer before enforcement action is taken, and the appropriate form will be generated by the system with all necessary taxpayer data.

### ❖ *Taxpayer Service Operations*

35. Of all the various operating functions of the tax administration, the staff of the taxpayer service function has by far the most interactions with taxpayers and the general public. They are, in effect the public face of the tax administration. Their attitude and demeanor will shape the taxpayers' feelings towards the tax administration. The staff must, therefore, be good communicators and have a genuine desire to assist the taxpaying public and have the ability to stay calm when faced with adversity. They must adopt the courteous and professional image which the tax administration must promote.

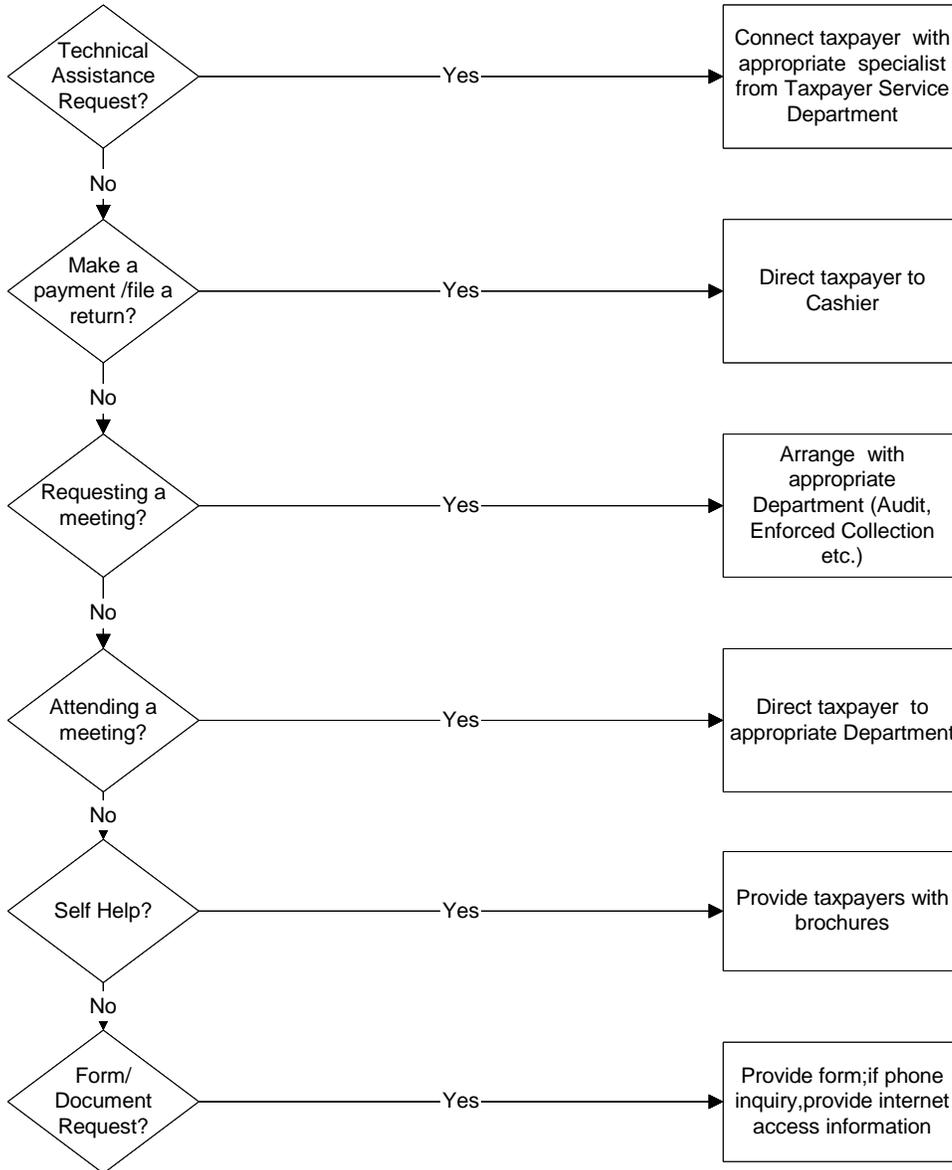
In most cases they are the initial point of contact with taxpayers. As such they are expected to have a good working knowledge of tax law, tax office procedures, filing requirements and the tax obligations of the taxpayer. It is essential that advice given by the Taxpayer Service function is correct and consistent.

As the initial entry point for most walk-in, phone in or written contacts, taxpayer service staff respond to common questions and route more complex questions to other taxpayer service specialists or staff from other functions as appropriate. The accompanying diagram depicts general workflow of operations when taxpayers visit a branch office of the tax administration.



# TAXPAYER SERVICE

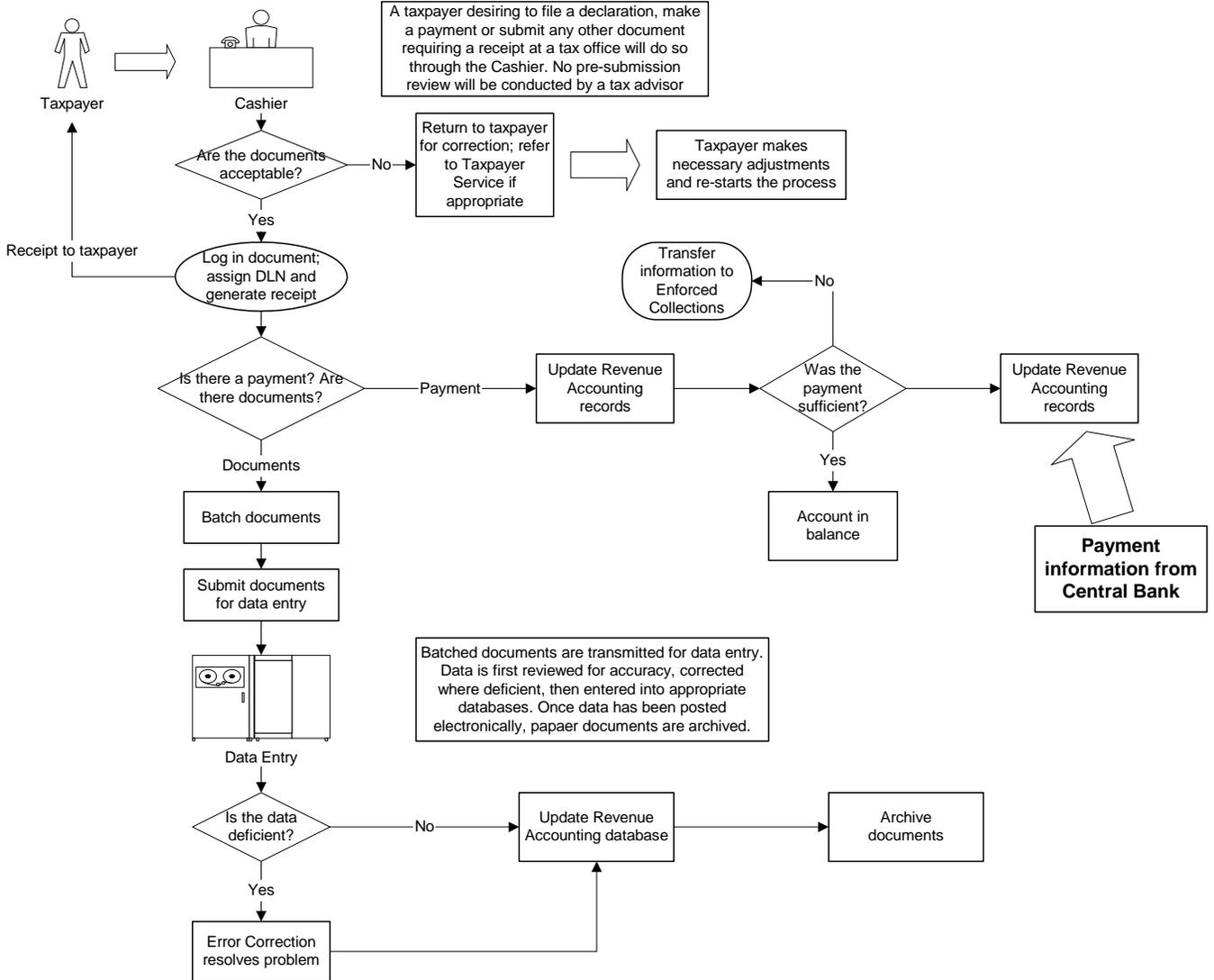
Upon entering a branch office, a taxpayer's first contact will be with the Taxpayer Service reception desk. From this point, they will be funneled to the appropriate personnel/Department.



## **Return Processing/Revenue Accounting Operations**

36. This “back office” function is responsible for all returns processing and revenue accounting activities; data and funds reconciliation; issuance of computer generated assessments, notices, and related documents. Data entry clerks input data from tax returns, related documents and payment data into the tax administration’s computer systems. The computer system does a mathematical verification of the tax return and generates a notice to inform the taxpayer. Other errors on the tax return are reviewed by an error resolution staff. These clerks should have good operational knowledge of the data entry procedures for all types of tax returns and related documents. Error resolution staff must possess a higher level of technical expertise. Additionally this function is responsible for data entry through electronic document scanning and electronic filing of tax returns. It processes all payments whether by cash, checks or electronic funds transfer. Payments are reconciled against tax liabilities and computer generated notices are issued for unpaid amounts. Refunds and offsets are also generated. Accounts must be reconciled on a daily basis and funds deposited in the government’s treasury account.

# RETURNS PROCESSING



## **Audit/Control**

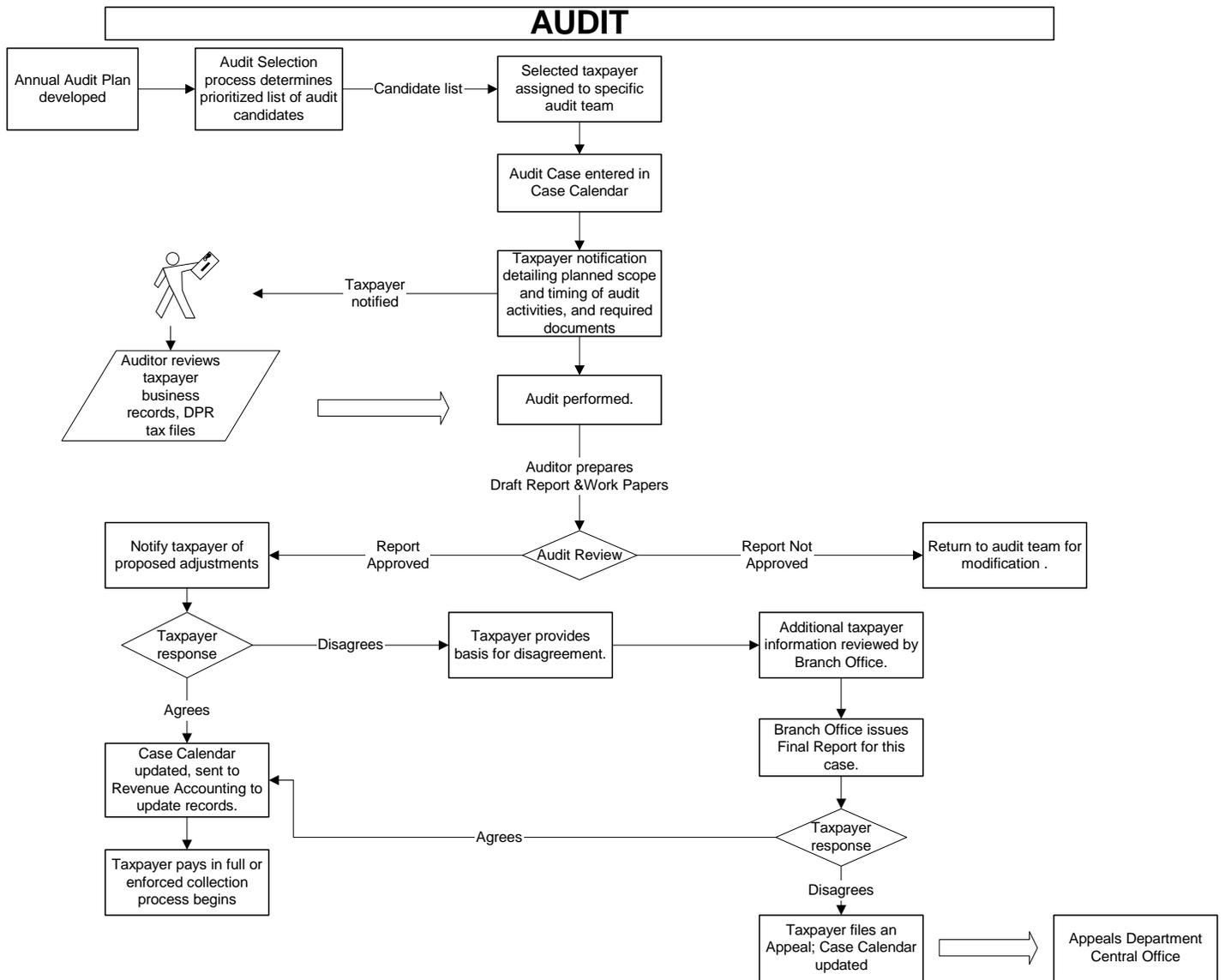
37. The function is responsible for managing a coordinated audit program for all taxes for which the tax administration is responsible (Income Tax, VAT, etc.). This does not necessarily mean that an auditor will be expected to do a complete audit of all taxes but rather that the Audit Department will adopt a coordinated approach in selecting and conducting audits. Whenever possible, income tax and VAT audits should be conducted simultaneously, even though different tax periods may be audited for each type of tax. For example, an income tax audit for 2002, 2003 and 2004 tax years and a VAT audit only for 2004 tax periods. This will enable common issues, records and areas of concern to be dealt with comprehensively.

38. The Audit Department must also develop close cooperation with all other Departments of the tax administration in particular; the Anti-Evasion Department – not only to ensure cases of suspected evasion are referred on a timely basis but also to volunteer the expert audit services of the Department in investigations being conducted; the Enforced Collections Department - to receive referrals of audit stop-filers or non-filers; and, the Appeals Department – to re-audit taxpayers who have produced new evidence during the appeal process.

39. The substructure of the department will include units to conduct both office audits and field audits. Additionally, auditors can be grouped by specialty, both by type of tax (VAT, Excise, Income, etc.) and type of industry (banking, manufacturing, retailers, etc.) Repeated focus on an industry will permit an auditor to become expert in the tax legislation issues and the necessary audit techniques related to specific industries.

40. A separate unit will handle audit planning, case selection and classification. Until an automated case selection system based on risk analysis is developed, this unit will manually assign cases based on rudimentary risk analysis criteria. Once the automated system is in place, staffing will be reduced but will still be necessary to ensure that the risk assessment system is functioning properly and to supplement it as appropriate. This is necessary to provide a small number of audits for compliance coverage even where the risk is relatively low, and to deal with newly discovered pockets of non-compliance.

41. Finally a separate audit review unit is necessary for post audit quality assurance and trend analysis. A strong accounting education is required for the staff assigned to perform income tax and specialty audits in the field (outside the tax administration's office). Staff handling simple office audits (where the taxpayer visits a tax administration office) and VAT audits or controls require minimal accounting skills. Auditors assigned to large case audits, audit classification, and audit quality review, should possess excellent skills and have significant experience in the department. All staff must be knowledgeable in tax law, audit techniques, and internal operating procedures. Along with all other public contact employees of the tax administration, they must possess good interpersonal skills and exercise good judgment in accomplishing their work assignments.

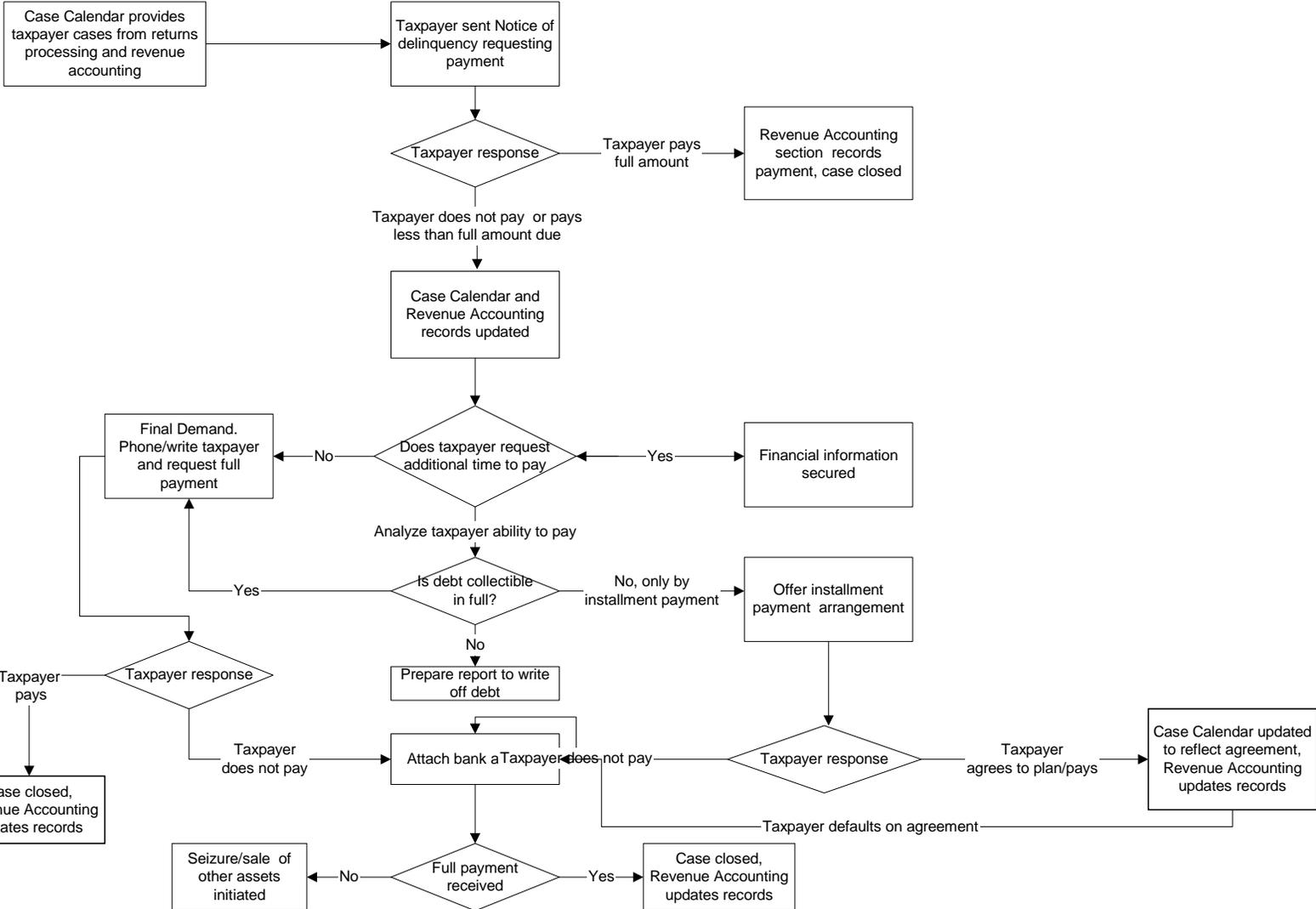


## **Enforced Collections**

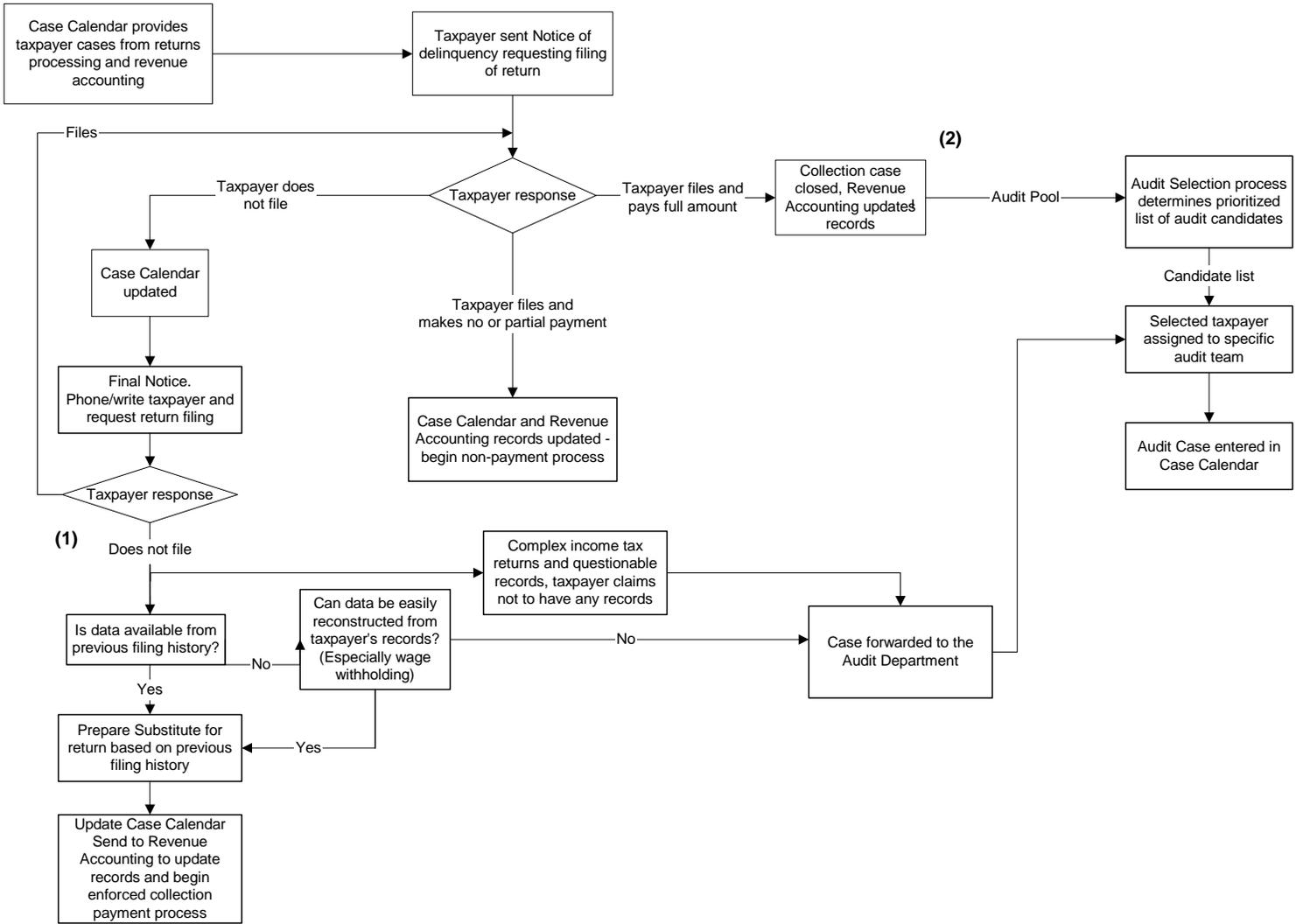
42. These activities focus on taxpayers who are delinquent in meeting their tax obligations. As discussed above, the returns processing and revenue accounting department systemically generates notices to the taxpayer when a balance due condition exists. This occurs when the taxpayer has paid less than the required amount of tax due (including any penalties or interest). Similarly, the returns processing and revenue accounting department systemically generates notices to the taxpayer when a required tax return is not timely filed. This occurs as a result of the computer system matching filed tax returns with each taxpayers filing requirements, established when the taxpayer registers with the tax administration. For simple tax returns, the Enforced Collection function may also be given responsibility to prepare the taxpayer's delinquent return, when the taxpayer does not do so, and sufficient data is available. Where insufficient data is available or an income tax or other complex tax return is involved, the case will be transferred to the audit department.

43. Enforced collection staff must be knowledgeable in tax law, collection techniques and internal operating procedures. As a cost saving measure, collection staff should employ all office collection methods possible before making field contact with taxpayers. The substructure of the department may contain both office and field collection units. Large and/or complex cases should be assigned to the most experienced staff. Because of the nature of their duties, enforced collection staff, more than any other public contact employees of the tax administration, will often encounter distraught taxpayers. For this reason, they must possess excellent interpersonal skills.

## ENFORCED COLLECTION - NON PAYMENT

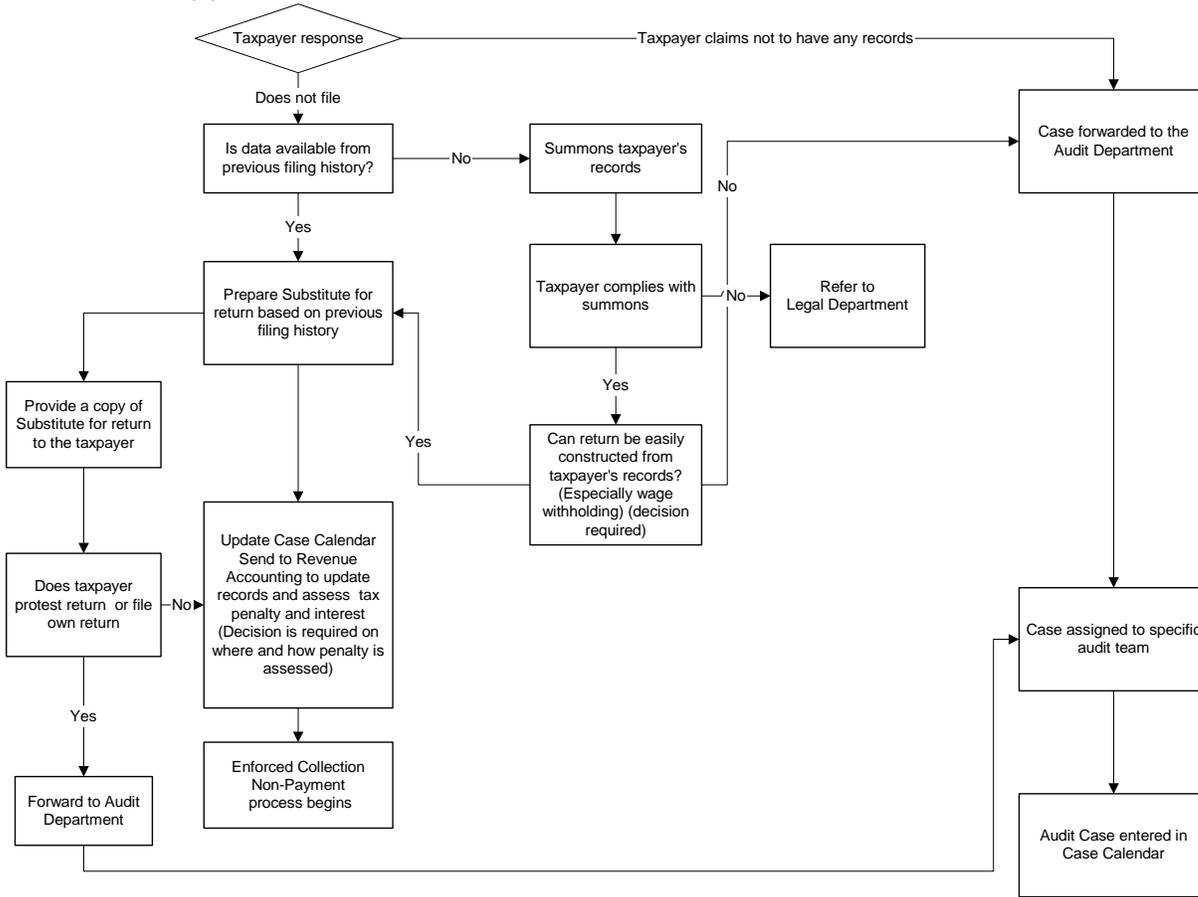


## ENFORCED COLLECTION - NON FILING

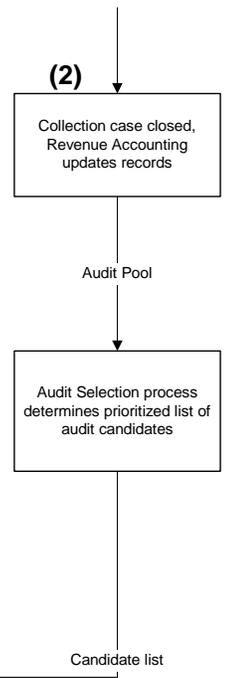


# COLLECTION NON-FILING / AUDIT INTERFACE

(1)



(2)



## Section VI

### VI. Measures of Tax Administration Effectiveness

44. The Strategic Business Plans of modern tax administrations contain goals against which their achievements can be measured. Additionally, a number of standard measures exist to determine both the overall effectiveness of a tax administration, as well as the effectiveness of key operational business processes. A number of standard measures are provided below. To the extent possible, baseline data should be collected before major reforms take place.

#### ❖ *Global Measures*

45. Three of the most significant overall measures of effectiveness are:
- The total operating costs of the tax administration expressed as a percentage of total revenue collections (voluntary and enforced collections)
  - Total tax revenue (adjusted for inflation/deflation) compared to prior years tax revenue
  - Voluntary tax payments as a percentage of total collections (voluntary and enforced collections).
46. Other global measures include:
- Total numbers of registered taxpayer by taxpayer class (type of taxpayer, type of tax and size of taxpayer) compared to prior years
  - Total delinquent account payments (adjusted for inflation/deflation) compared to prior years
  - Amount of delinquent account payments as a percentage of total delinquent account inventory
  - Number of tax administration employees as a percentage of total number of taxpayers
  - Public opinion of taxpayers concerning the image of the tax administration

#### ❖ *Functional Measures*

47. Audit
- Total amount of audit assessments collected as a percentage of total amount of assessments
  - Number of audits
  - Number of audits broken down by tax class
  - Yield per hour, by tax class
  - Total assessments recommended by audit
  - Total refunds as a result of audit
  - Number of non-agreed assessments upheld by Appeals as a percentage of a total number of assessments referred to Appeals

- Value of non-agreed assessments upheld by Appeals as a percentage of a total value of assessments referred to Appeals
  - No change rate ( no tax assessed or refunded) by tax class
  - Average time per case by tax class
  - Percentage of direct time (time spent working cases) to total time (time spent working cases plus vacation time, sick time, administrative time, training time, etc.
48. Enforced Collection/ non-payer
- Number of enforced collection cases closed
  - Number of enforced collection cases closed as a percentage of enforced collection cases in inventory
  - Total revenue collected through enforcement actions
  - Revenue collected per staff hour
  - Total delinquent tax account inventory, by number and amount, type of tax, and age of accounts
  - Number of enforcement actions: bank account attachments, attachment of third party receivables, etc.
  - Total revenue collected by type of enforcement actions
  - Total revenue collected broken down by tax , penalty, and interest
49. Non-filer activities:
- Number of delinquent tax returns secured
  - Revenue collected as a result of securing delinquent returns
  - Revenue yield per staff hour
  - Average number of hours for securing the return
  - Percentage of returns secured with full payment
  - Number of substitute returns prepared by the tax administration when the taxpayer has failed to file voluntarily
50. Prevention and Detection of Tax Frauds:
- Number of tax fraud cases closed
  - Number of tax fraud cases brought to court
  - Guilty verdicts as a percentage of fraud cases brought to court
  - Revenue collected from fraud cases
  - Yield per staff hour on fraud cases
  - Total publicity on fraud cases: number of cases, number of newspaper articles, etc.
51. Appeals:
- Total number of appeals cases closed
  - Number of appeals cases where assessments are not upheld by court as a percentage of total number of appeals cases

- Value of appeals cases where assessments are not upheld by court as a percentage of total value of appeals cases
- Average elapsed time per appeals case
- Average time per appeals case, by class of taxpayer

52. Taxpayer Service:

- Number of taxpayers assisted, by phone, by walk-in and by correspondence
- Correct answers given to taxpayers as a percentage of all answers given to taxpayers (sample review)
- Average delay time in waiting for phone service, walk-in service and responses to correspondence
- Number of telephone busy signals as a percentage of taxpayer telephone attempts (sample review)
- Number of published information materials distributed to public
- Number of courses given to public, total attendance

53. Returns Processing and Revenue Accounting:

- Number of returns processed
- Average amount of time to process a return
- Error rate in processing tax returns
- Error rate in processing of payments
- Elapsed time per return to complete all processing
- Elapsed time to deposit all cash receipts into tax administration bank account

54. Training:

- Number of courses developed for employees
- Number of courses conducted
- Number of employees who complete courses
- Percentage of employees who pass test

55. In addition to the above statistical measures, taxpayer surveys can also be used as a qualitative measure of tax administration effectiveness. This can be done in a variety of ways, including through sampling using written instruments and focus group interviews. It is preferable to begin the survey process before implementation of major tax administration reforms in order to establish a baseline against which future surveys can be compared.

## Section VII

### VII. Building the Foundation for Best Practice Tax Administration Reform

56. Requirements for major reforms to a developing country's tax administration are similar to other public sector reforms. Major changes require the political support of the government. Only marginal improvements can be made without such support. The reform of tax administration is a long-term process and requires a number of elements to be put in place to operate effectively. Legislative changes will normally be required, the extent of which will vary by country. The tax administration's business processes must be reviewed and restructured and an organization structure that facilitates implementation of the reforms must be put in place. Other major elements include: a competent, well trained, motivated, and ethical work force; an integrated information management system based on a unique taxpayer identification number to support operations and serve as its backbone; and efforts to combat internal and external corruption. Significant funding must be made available to undertake meaningful reform and this usually implies grants or loans from international sources. This is especially true as regards purchase and development of the necessary information systems infrastructure for the tax administration. As would be expected, resistance to major changes in the tax system can be anticipated from those who perceive them as a threat to their interests. Unfortunately this usually includes some employees of the tax administration, who derive personal benefits and rents from the current non-transparent and discretionary system.

#### ❖ *Legislative Framework*

57. A legislative framework must be in place which clearly: specifies the taxes to be administered; provides a rational system of sanctions for failure to comply; and specifies the rights and responsibilities granted to the tax administration; and, the rights and responsibilities of taxpayers. These will be covered in greater detail below. To the extent possible the tax administration should not be used to administer or enforce non-tax obligations including license fees and fines. The legislation should specify that the head of the tax administration becomes the principal official of the government responsible for the assessment and collection of national taxes. The head of the tax administration must be given the legal authority (subject to appropriate oversight) to organize the administration of taxes in the most efficient and effective way. This includes control over the central (or headquarters) office as well as all branch offices, and the authority to determine the number and location of both tax administration staff and offices. Some countries, including the United States and the United Kingdom and have enacted or developed a specific Taxpayer Bill of Rights (Annex1) or Taxpayer Charter (Annex2) which summarizes rights and responsibilities – switch to annexes. The OECD has also developed guidance with respect to taxpayer rights and responsibilities. (Annex 3) Taxpayer rights and responsibilities generally include:

- The obligation to register with the tax administration and to secure a taxpayer identification number.

58. This is true for both natural and artificial persons (individuals and business entities). It must be accomplished prior to incurring any tax liability or filing requirement. Registration information includes the taxpayer's name, address, and type of business. Taxpayers must also indicate the types of taxes for which they may be liable and/or required to file tax returns or information documents. Taxpayers are required to notify the tax administration of any changes in name, address and filing and/or payment requirements. Taxpayers are required to use their tax identification when submitting their tax returns, information documents, making tax payments, or issuing invoices.

- The obligation to file and pay taxes

59. Taxpayers are required to file and pay taxes for which they are liable and within the timeframes required by law. Taxpayers are also required to pay any penalties and interest which the law requires as a consequence of their non-compliance.

- The obligation to maintain books, records, invoices, and other financial data.

60. Taxpayers must keep this material to serve as substantiation of information they report on their tax returns. The burden of proof of any deductions or credit is on the taxpayer. Taxpayers are required to make tax-related information available in the course of an audit or investigation by the tax administration.

- The right to appeal

70. Taxpayers should be given the opportunity to administratively appeal decisions taken by the tax administration. These usually relate to actions taken in the audit process resulting in additional tax liability. The review should be conducted by specialized staff of the tax administration (see Appeals Business Process below). Taxpayers should also be able to pursue appeals through the courts.

- The right to be treated in a fair, impartial, professional and respectful manner.

71. Tax administration staff should be required to treat all taxpayers with dignity and respect. Taxpayers who believe they are being unfairly treated have the right to complain to an employee's supervisor. Staff must follow uniform procedures in dealing with all taxpayers.

- The right to confidentiality and privacy

72. Taxpayer's have the right to expect that their personal, business and financial information be kept confidential. Employees illegally disclosing such information are subject to both administrative and criminal penalties.

- The right to receive assistance and information in meeting their tax obligations

73. Tax administrations are obliged to inform taxpayers of their tax filing and payment responsibilities and to provide basic assistance. Taxpayers must be given access to tax returns and informational publications.

- The right to be represented in dealings with the tax administration

74. Subject to appropriate written request, taxpayers have the right to be represented by someone else in their absence and/or to have someone else be present in their dealings with the tax administration.

- The right to receive a refund of overpaid taxes.

75. Taxpayers have a right to receive a timely refund of overpaid tax (including VAT) in the manner prescribed by law and regulations.

76. Tax administration rights and responsibilities also include:

- The right to assess and collect tax, penalties and interest

77. This includes the right to assess additional tax based on mathematical errors and/or the results of an audit. Penalties may be imposed for late filing, late payment, underreporting, or other violations of tax laws and regulations.

- The right to take administrative and/or legal action to enforce the collection of delinquent taxes.

78. This includes the right to place a tax lien and/or attach liquid and fixed assets (e.g., bank accounts, accounts receivable, merchandise, motor vehicles, machinery, real property, etc.)

#### ❖ *Restructuring the Tax Administration*

79. A crucial element in the tax administration reform process is to review and revise the organizational structure. The new structure must support and facilitate the implementation of the reforms. There is no one organizational structure that fits all countries. That said, however, there are three basic ways to structure a tax administration; by type of tax; by type of taxpayer; or, by operating function.

- Type of Tax

80. Under this organizational configuration a separate division or department of the tax administration is responsible for each type of tax collected in the country; e.g. Income Tax; VAT; Excise Tax; etc. Employees, who enforce the tax laws, provide assistance and advice to taxpayers, and who provide support services and conduct back office operations, specialize in one type of tax. Countries in the early stage of development or transition are generally organized by type of tax. This mainly involved a department to

administer income and profit taxes and a separate department to administer sales taxes or VAT. Most countries have moved away from this organizational structure. The United Kingdom was among the last OECD countries to do so when they combined their Department of Inland Revenue with the Customs and Excise Department. Among the few countries maintaining separate Income and VAT organizational structures are Bangladesh and Egypt.

- Type of Taxpayer

81. Under this organizational configuration a separate division or department of the tax administration is responsible for each type of taxpayer in the country; e.g. large taxpayers; medium taxpayers; and small taxpayers. Employees, who enforce the tax laws, provide assistance and advice to taxpayers, and who provide support services and conduct back office operations, specialize in one type of taxpayer. Some of the more advanced tax administrations have adopted this type of structure including the United States and New Zealand.

- Functional Structure

82. Under this organizational configuration a separate division or department of the tax administration is responsible for each major business process or activity performed by the tax administration; e.g.; audit/inspection; taxpayer service; returns processing and revenue accounting; collection; etc. Employees, who enforce the tax laws, provide assistance and advice to taxpayers, and who provide support services and conduct back office operations, specialize in one activity or business process. The vast majority of all other tax administrations are organized primarily along functional lines.

83. However, modern tax administrations usually contain some features of all three structures and all vest overall authority to a centralized head of tax administration for the country. The best practice consensus for developing countries is an organization based on function and featuring a large taxpayers unit.

84. The organizational status and location of the tax administration in overall governmental structure is another issues to be addressed as part of the reform process. Tax administration has traditionally been a subordinate structure of the Ministry of Finance

- Relationship with the Ministry of Finance

85. Although tax administrations may and should make recommendations on legislation dealing with its powers and responsibilities, tax policy issues are the province of the Ministry of Finance and the legislature. The tax administration, however, should provide inputs dealing with its ability to administer new legislation from both a practical and resource perspective. The administration of the tax laws must be transparent and free from political influence. OECD countries have enacted legislation which severely

restricts the disclosure of case related tax administration data to bodies external to the tax administration, included the Ministry of Finance.

- Combined Revenue Authorities

86. In most developed countries the tax administration is also responsible for the collection of the national governments' employer and employee social security insurance (pensions, and various benefits related to temporary or permanent disabilities; death and survivor benefits); health insurance; and unemployment insurance taxes and contributions. While these are sometimes called "contributions" as opposed to "taxes" they are essentially one and the same. However, the administration of the social benefits system, i.e., the determination of eligibility for, and payment of, benefits is vested with other governmental bodies. This is, also, the recommended approach in developing countries.

87. A recent trend has been the integration of Customs and Tax Departments into a single Revenue Administration. Some member countries of the European Union find this an attractive option as the existence of common customs and tariff regimes reduces the need for a large customs organization. Combined Revenue Authorities can either remain subordinate to the Ministry of Finance or be structured as Independent Revenue Authorities.

- Independent Revenue Authorities

88. While most tax administrations in OECD countries are an organizational component of the Ministry of Finance, another trend has been the formation of independent or quasi-independent revenue authorities, as is the case in the Ireland, Latvia, Rwanda, and Uganda to name only a few. There, revenue authorities have a separate budget authorization and exercise more control over their budget than other government bodies. All or some staff members are given specified length employment contracts. Employees are not restricted to civil service pay scales but in return lose certain civil service protections and can be terminated upon the expiration of their contract.

❖ *Best Practice Organizational Structure*

89. The consensus of tax administrators around the world is that an organizational structure based on function with a large taxpayer unit is best suited for modernization efforts in a developing country. The exact design including the number and location of offices will vary from country to country. Factors such as: population distribution; geography; the nature of the economy; infrastructure; social and cultural conditions; etc., must all be taken into account. It is a well accepted principle that the largest 20% of taxpayers in a developing country produce 80% of tax revenue, making the case for creation of a large taxpayer unit. It is also suggested that the tax administration should eventually be responsible for the collection of all social taxes or contributions. However, a tax administration may not have the capacity to absorb these additional responsibilities

until it has moved made progress with its own reforms. The functional organization structure will be covered in greater detail below.

- Centralization/Decentralization Issues

90. In a functionally structured tax administration the central or headquarters office is responsible for the overall development, improvement, management, and automation of all subordinate units. Activities include: strategic and tactical planning; information systems development and management; the development and maintenance of operating policies and procedures; designing and developing employee performance standards; training development; establishing reporting requirements; evaluating functional performance and performance of field offices; establishing, implementing and monitoring integrity standards; formulating the tax administrations budget and monitoring its budget execution; and providing other centralized support services.

91. Except where the large taxpayers unit is part of the central office, the main responsibility of field offices is to implement and apply policies and procedures developed by the central office in processing taxpayer accounts and working taxpayer cases. The bulk of the tax administration's staffing is located in field offices. In a nutshell the central office develops and manages programs while field offices manage cases and develop staff.

❖ *Strategic Planning*

92. An integral part of successful implementation of major reforms to establish a best practice tax administration requires the development of a strategic business plan (SBP). The strategic business plan contains the tax administration's vision and mission statements, strategies, objectives, goals, actions items, timelines, and measurement tools. It typically covers a three to five year period, lays out what actions will be taken in each year of the plan, and is updated annually. Recently developed mission statements include the following elements:

- collecting the proper amount of tax at the lowest possible cost;
- continuously improving the quality of service to taxpayers;
- achieving the highest possible level of public trust in its integrity, effectiveness and fairness.

93. The development and implementation of business process reengineering, information systems planning, transition planning and implementation and all other major changes to improve the tax administration should be addressed in the SBP. Examples of strategic business plans from selected countries in various stages of development include Latvia (Annex4),Tanzania (Annex5),Uganda (Annex6),and Rwanda (Annex7).

Most established tax administrations also publish annual reports detailing their accomplishments. They also provide an opportunity for the government to display both revenue sources and revenue expenditures. Such is the case in Latvia. (Annex8)

### ❖ *Restructuring Using Business Process Re-Engineering*

94. The modernization of a tax administration requires the development of a restructuring plan to provide the methodology to be employed and guidelines to be followed. While all modern tax administrations operate using common business processes (e.g. returns processing, revenue accounting, audit/inspection, enforced collection, etc.), the restructuring plan must define how these business processes will be designed to produce the most effective and efficient tax administration system for the developing country. The oversight of this plan and the assignment of key staff to develop and implement it, is best placed in the hands of the head of the tax administration or a principal deputy. A restructuring committee should be formed and staff should be made available on a full time basis. This is time consuming and difficult work. However, it represents the future of the tax administration and must be given the highest priority and the necessary human and financial resources must be made available.

95. Typically the methodology to be used in the restructuring effort first requires a comprehensive review and documentation of current operations. This is not a simple task as the central or headquarters tax office may not have developed universal operating procedures and branch or local offices may each operate in a somewhat different fashion. Once current processes are documented, the restructuring committee, usually with the help of experienced foreign technical advisors, must determine how to streamline operations to improve effectiveness and efficiency.

96. High level data flow diagrams or flow charts of the new business processes and their interrelationships must be developed. Decisions must be made as to where various processes and procedures should take place, i.e. in centralized or decentralized locations. Staffing and skill level needs must be determined and compared against existing staff capabilities. This will result in a revised organizational and staffing structure. Detailed operating procedures will then have to be developed and formalized for staff to be trained and to provide work guidelines. This process must be done in conjunction with internal or external information systems developers in order to produce an information systems plan to automate and support the new business processes and work procedures. A timetable must be established to implement the new system and structure while maintaining current operations. This, in turn will require transition planning.

### ❖ *Information Management System and Unified TIN*

97. Both the tax administration and the taxpayer benefit from the assignment of a single and unique taxpayer identification number. This critical element must be in place at the beginning of the reform process. Based on taxpayer registration information, the tax administration uses this number as a foundation for the development of a computerized taxpayer master file. The master file contains: a listing of all types of taxes for which the taxpayer is liable; the taxpayer's filing and payment history for each type of tax, by tax period; and other basic information such as the name, address and nature of the taxpayer's business.

98. An information management plan is required to determine the computer and data communication hardware and software necessary to support the reform and redesign of the tax administration. Using the unique taxpayer identification number and taxpayer master file as its basis, the new information system must be able to track the status and location of taxpayer cases and control case movement through the various business processes through which it must pass. Software application programs will be required for each business process to support the implementation of case processing procedures. The information systems plan must include specifics as to the nature, number, location and delivery dates of computers; servers; data communication and other hardware; the development and implementation of applications software based on new business processes; automated tracking and control of taxpayer cases; and management reporting capabilities. Training both computer and operational staff in the new system is, also, an integral part of the plan.

#### ❖ *Change Management Process*

99. Change management principles should be followed in the restructuring and reform of the tax administration. A concentrated effort must be made to secure the “buy-in” of management staff at all levels. An internal communications process must be established to: keep employees apprised of the reform timetable; communicate the rationale for the changes; provide an opportunity to make suggestions to streamline operations; and advise them of organizational changes that will impact them. Some employees will have their jobs eliminated, significantly redesigned or moved to other offices. These should be identified as early as possible. To the extent possible, training should be made available for employees to learn new skills. A staff redeployment plan should be made a part of transition planning. An external communications plan should be developed to secure the buy in of taxpayers, trade and business associations, impacted governmental organizations, and other external stakeholders.

#### ❖ *Written Procedures and Technical Rulings*

100. As discussed above, written operating procedures are required to ensure that tax administration staff properly works cases through each business process. These must be followed in all offices of the tax administration to ensure that taxpayers are treated in a uniform manner regardless of their location in the country. Tax administrations must also uniformly apply the tax laws and regulations. Technical issues often arise regarding how the law and regulations will be applied in specific circumstances and a ruling is requested. A formalized system is required to document and publish rulings that could impact similarly situated taxpayers, as well as certain “private” rulings. Taken together this formal system guiding tax administration behavior provides transparency, which is one of the elements required to demonstrate the integrity and fairness of the tax administration system to all taxpayers.

#### ❖ *Human Resource Management*

101. Professional well trained and respected employees are the most important asset of any modern tax administration. Low wages, an absence of performance management systems, minimal formal training, and poor treatment by management staff are too often the norm in developing tax administrations. Employees have little incentive to treat the taxpayers they contact in the professional and courteous manner they deserve. Low wages, along with an absence of formalized written procedures and internal controls also provide a breeding ground for employee corruption.

102. It is difficult to increase overall staff compensation in most developing countries due to fiscal constraints and linkages to other public sector employment. This is especially true where there is no government-wide position classification system based on education, experience, and training. However, even within funding constraints, best practice tax administrations must move forward to develop a transparent performance management system. Employees should be evaluated annually on overall job performance based on critical success factors, and promotions must be based on these performances. Non-monetary employee recognition programs should be explored, including special assignments and training. Training programs must be expanded to include:

- employee orientation and responsibilities
- basic functional procedures and techniques training;
- tax law training;
- computer training;
- advanced technical training;
- basic management training;
- advanced management training;
- train the trainers training;
- The development and design of training programs as well as personnel management

This requires the use of specialists in these fields as well as technical specialists from the operating functions of the tax administration. Some tax administrations, like Tanzania and Lithuania have developed their own tax administration training academies.

#### ❖ *Voluntary Compliance and Risk Management*

103. Developed countries base their tax systems on self-assessment by taxpayers and their voluntary compliance with tax laws. They also employ PAYE and other withholding at the source by banks and other third part payers. Invariably there are gaps between the total amount of taxes that should be paid and the total amount that is actually paid. Tax administrations must discover the nature and reasons for these gaps and determine which treatments should be applied within resource constraints to increase compliance and maximize revenue collections.

104. Risk management is an iterative process that consists of well-defined steps to support improved decision-making. The compliance risk management process is an integral component of a revenue body's strategic management framework. It is used in modern tax administrations as a structured process for the systematic identification,

assessment, ranking, and treatment of tax compliance risks (i.e., various forms of taxpayer behavior resulting in a failure to register, to file returns on time, to properly report tax liabilities, and to pay tax). It can be used in two ways: (1) at a strategic or high level for the whole country or specific regions to identify non-compliance behavior or trends; or (2) at the operational level to identify specific taxpayers. At the strategic level the answers to three questions are required.

- 1) What are the key compliance risks to be addressed?
- 2) Which groups of taxpayers do they relate to?
- 3) How should these risks be treated to achieve the best possible outcome?

105. Examples of possible treatments include:

- 1) Targeted taxpayer education efforts
- 2) Targeted audits
- 3) Non-filer/stop-filer initiatives
- 4) Expanded enforced collection activities
- 5) Changes to the structure and application of penalties
- 6) Additional record keeping and information reporting requirements
- 7) Redistribution of tax administration resources between functions and/or offices
- 8) Improved coordination with and access to databases of other governmental organizations
- 8) Tax treaties and information sharing agreements with other countries
- 9) Rulings to clarify applications of the law
- 10) Additional changes to tax administration operating procedures
- 11) Recommendations for legislative changes
- 12) Targeted tax crime investigations and prosecutions

106. Modern tax administrations are able to routinely apply risk management to their business processes (audit, collection, etc.) because they have highly skilled specialized staff; have successfully conducted compliance research programs; and have accumulated significant historical taxpayer profiling and results data. They also possess significant computer processing and analysis capabilities to use this data in prioritizing, selecting and assigning taxpayer cases at the operational level. Since modern tax administrations have limited resource availability they must target their activities towards those taxpayers where loss of tax revenue is at greatest risk. This is especially true with regard to the audit function where only a small percentage of taxpayers can be audited.

This is usually not the case in developing tax administrations. Risk management at the strategic level must be addressed as part of the development of a strategic business plan to create the necessary framework, while short-term initiatives should immediately be undertaken at the operational level. This is not any easy task in developing countries as, for example, results of prior compliance activities may not be well documented, maintained or analyzed. The majority of prior tax administration compliance activities, especially as regards small and medium businesses, may have been devoted to inspection or control visits as opposed to financial audits. The former require minimal accounting skills or expertise and are most useful for checking VAT compliance as opposed to profit or income taxes. Inspection or control visits normally consisted of a cursory review of

books, records, cash register receipts and a physical inventory of goods. As stated above, these inspection visits can be intrusive and often target the same taxpayers regardless of risk. Results of these inspections are not usually employed to determine and treat the root causes of non-compliance.

107. Development of a risk analysis system at the strategic level is a multi-year process. Developing tax administrations can initially most successfully apply risk management concepts at the operational level in the audit process for small and medium taxpayers. One hundred percent of large taxpayers should initially be subject to audit, but the depth and frequency of audit should be adjusted based on prior results. Rudimentary risk analysis can be accomplished even before the implementation of an integrated management information system. It should be as a tool for identifying which taxpayers are prioritized and selected for audit based upon predefined criteria. Auditors, however, must first be trained in proper audit procedures and techniques. Audits must be conducted using these techniques and procedures and taxpayer profile data, audit results and auditor time expenditure must be collected and analyzed in a uniform manner. These audit results can then be used to develop an operational audit plan. Cases can then be prioritized and selected for audit, and results can then be documented. Some of the factors to be used in selecting and prioritizing cases for audit include:

- Results of previous audits
- Non-filer/stop-filer cases
- Tax period to tax period comparisons
- Industries with known compliance problems (e.g., alcohol, tobacco, oil and gas, etc.)
- Unusually high business expenses
- Low profit margins
- Questionable receipts
- Unusual balance sheet items

It should be noted that case selection can not only be based on certain taxpayers where the risks of non-compliance are the greatest. Some degree of compliance coverage must be provided to all types of taxpayers, regardless of their size, type of business or location. This is necessary to provide a deterrent for future non-compliance.

Additional OECD material on risk analysis is being provided (Annex9 and Annex10)

## Section VIII

### VIII. Reducing Corruption in a Tax Administration

108. Implementation of a best practices tax administration will significantly reduce the level of staff corruption. Specific requirements include:

- Establishment of an Internal Controls and Investigations unit.

109. The major duties of such an organization are described above and usually involve two major areas: reviewing the adequacy of internal controls; and, conducting investigations of employee misconduct. It is imperative that this organization report directly to the head of the tax administration. This unit can conduct investigations and internal audits based on requests and referrals from tax administration and external sources as well as to generate its own investigations and audits based its own assessment of tax administration. The U.S. Internal Revenue Service, and the Latvian State Revenue Service, are but two of many revenue bodies with this organizational component.

- Development of a Code of Conduct

110. The establishment and enforcement of a code of conduct is vital to help ensure the integrity and ethical behavior of tax administration employees. The code defines and provides examples of acceptable staff behavior as well as defining prohibited activities, potential conflicts of interest, and unauthorized disclosures of confidential information. Public contact employees of the tax administration are provided with photo IDs displaying their names and titles. The proper use of these IDs or credentials is, also, governed by the code of conduct. The code makes mandatory the reporting of misconduct on the part of other employees. All employees should be given an orientation course providing the rationale behind, and application of, the code of conduct in their professional and personal activities. A presentation on the code of conduct must be incorporated into new hire training. Additionally, employees should be required to certify in writing that they have received a copy of the code which should be placed in their personnel file. Violations of the tax administration's code of conduct can result in administrative sanctions up to and including dismissal of an employee. This is in addition to any prosecution for criminal acts covered by the tax and/or other legislation. Additional information on codes of conduct including case studies for Pakistan, Tanzania, and Bosnia-Herzegovina can be found in Annex11.

- External Oversight

111. Another anti-corruption tool is oversight, audit and investigations of tax administration operations and staff by special purpose governmental entities. These organizations may be located in the executive, legislative and/or judicial branches of the government and deal with corruption or abuse in the public sector.

- Separation of Duties/Specialization

112. One of the benefits of an organizational structure based on type of function is that it reduces the impact of any one employee in managing a taxpayer's account.

Enforcement staff (audit and collection) are only assigned cases after back office employees and computer systems have been involved in mathematical verification, data entry, and processing operations. Separate staff handle audit and enforced collection cases. Even in the audit process different employees handle case selection, auditing and quality review tasks.

- Improved Management of Human Resources

113. Actions taken to improve the conditions of employment and work environment of tax administration staff can also reduce corruption. This includes basing staff hiring and promotions on objective criteria. The qualification required for each position must be formalized and job standards developed for every type of position (e.g. auditor, taxpayer assistor, data entry clerk, fraud investigator, etc.) This must also be done for management positions. Employees should receive written evaluations at least annually based on these qualifications and standards. The role of the first level manager must change from that of a super technician to a developer of people. Proper wages, training, equipment and facilities must be provided.

114. Finding the necessary funds for all of this is one of the thorniest issues that must be dealt with. As discussed above, taking the tax administration out of the civil service is one possibility. Another possibility is to allow the tax administration to retain a small portion of revenue collections. This must be managed extremely carefully and in a transparent manner so as not to create a negative perception of the tax administration. Enforcement employees should not receive additional pay based upon individual audit assessment or enforced collection goals.

- Vetting New Hires

115. Potential hires should be screened and their background checked to ensure that they conform to the high standards of the tax administration as reflected by the code of conduct. Interviews with potential public contact employees should be structured to determine if they possess the appropriate attitude and demeanor to properly represent the tax administration.

- Rotation of Enforcement/Audit Staff

116. There is a danger for integrity breaches if compliance staff is assigned to work cases on the same taxpayers over an extended time period. For this reasons the case assignments and/or tax office assignment of staff should be rotated every two or three years.

- Risk Based Audit Case Selection

117. A risk based audit selection system reduces the potential for corruption by ensuring that audits are conducted based on risk as opposed to other factors. Additionally

modern tax administrations normally limit the number of consecutive tax periods that can be subjected to audit unless prior audits result in additional tax liability being assessed.

- Taxpayer Self-Assessment

118. The risk of employee corruption is reduced under a self-assessment system where the taxpayer or the taxpayer's authorized representative (as opposed to tax administration staff) prepares and files tax returns

## Section IX

### IX. Reducing the Burden on SME Taxpayers

119. A number of initiatives can be taken by government in the tax field to foster the growth of small and medium enterprises and/or reduce the paperwork burden that SMEs face. Measures which have the greatest impact are those which are established by tax legislation. Though tax policy is not the major thrust of this paper, a brief mention of some of these measures follows, along with measures that the tax administration can employ.

#### ❖ *Tax Policy Measures*

120. Special tax regimes, rate structures, incentives, and accounting rules are commonly applied to small and medium businesses. These include:

- Exemption from VAT registration and filing based on threshold amounts proscribed by law. However, small businesses with turnover under the threshold amount may be permitted to opt into VAT.(e.g. Albania, Bulgaria and most other countries with VAT systems)
- Simplified recordkeeping and/or accounting rules for small business taxpayers (e.g. Ireland).
- Single tax for small taxpayers combining all types of taxes (income, VAT, etc.)(e.g. Kosovo)
- Presumptive tax based on the size, location, and type of business activity for small enterprises (e.g. Spain)
- Progressive income tax rates based on net profits (e.g. Iceland)
- Tax allowances or exemptions based on net profits (e.g. France)
- Tax holidays, incentives, or relief from taxation based on new business investments. Almost all countries employ some form of grant, subsidy, investment credit or deduction.

Tax policy measures in specific countries are subject to change. The reader is directed to annexes 12 and 13 for additional information on tax policy issues.

#### ❖ *Tax Administration Measures*

121. The following measures are normally incorporated in the reform of the tax administration.

- Simplified Registration and Unique Taxpayer Identification Number. This is normally the first measure to be put in place. In some countries, including most of the former Yugoslav republics, the same identifying number is used for all business registration purposes with government agencies, including the tax administration. This number must also be used to open a bank account. (This is usually the starting point in reform efforts)
- Transparency of tax administration policies and procedures. With limited exceptions, written tax administration policies and procedures should be made

- available to taxpayers. This can serve as a guide in explaining taxpayer rights and responsibilities as well as the consequences of non-compliance with the tax laws
- Uniform application of laws, regulations, policies and procedures. Certainty is a prized commodity in the business community.
  - Highly skilled, helpful, and ethical staff who can resolve tax issues professionally in reasonable timeframes.
  - Risk Assessment/Limitations on Audits. The proper use of risk management in the audit case selection process will minimize the number of audits of compliant taxpayers as will limiting the number of audits that result in no change to the amount of tax due.
  - Increased taxpayer assistance and educational programs. This can include internet services and electronic filing of tax returns where technology and legislation permit. Electronic payment of taxes through the banking system should also be utilized. The small business taxpayer may particularly benefit from providing taxpayer services after normal business hours and weekends.
  - Tax Return Simplification. Tax returns can be designed to be as short and simple as possible. Small taxpayers in particular would benefit from the use of “plain language” tax returns and instructions. Both tax returns and accompanying instructions should be provided free of charge.
  - Less frequent Return Filings. Monthly tax returns should be discouraged wherever possible, especially for small business taxpayers.
  - Simplified Recordkeeping. Small business taxpayers should not be subjected to the same recordkeeping as large corporations. Small business taxpayers should be permitted to use cash accounting methods
  - Single Return for Employment Taxes. A single return can be used by employers to report all employee wages; all employer withholding for income tax and social taxes (pension, health, unemployment, etc.), and employer contributions for social taxes.
  - Special Assistance to New Business Taxpayers. When small business taxpayers register with the tax administration they should be provided with all the necessary information, tax returns and instructions they will need to meet their filing and paying requirements. Some countries provide a “Small Businessman’s Kit” for this purpose. The time spent in guiding the new taxpayer through this process saves both the taxpayer and the tax administration time and resources in the long run, and can provide a favorable image of the tax administration.
  - Creation of Business Advisory Panels. Some tax administrations establish business advisory panels. These panels provide a forum for business taxpayers to voice their concerns over tax administration procedures or practices that they consider unnecessarily burdensome, and to suggest practical alternatives. These panels are also used by the tax administration to seek input prior to implementing new programs and procedures that will impact the business community.
  - Liaison with Chambers of Commerce and Business Associations  
Tax administrations have found it useful to periodically meet with chambers of commerce and business associations. This also presents a forum for the business community to provide valuable feedback on tax administration operations. Additionally industry specific associations (traders, bankers, etc.) can be used as a

sounding board for new procedures or regulations which will impact their members

- **Coordinated and Package Audits.** To reduce the number of tax audits, all types of tax returns for which the taxpayer is liable should be reviewed at one time as part of a “package” audit. Multiple tax periods should also be covered at one time. In tax administrations utilizing special auditors for VAT, information should be shared with income tax auditors to minimize asking the taxpayer to provide the same material more than once.
- **Expedited VAT refunds.** Tax administrations should adopt procedures to expedite VAT refunds, particularly for taxpayers who have a good compliance history.
- **Penalty Waivers.** Taxpayers should have the right to seek waiver of certain penalties assessed by the tax administration for reasonable cause. Examples of reasonable cause include waiving late filing penalties caused by natural disasters and other circumstances over which the taxpayer has no control.
- **Payment Plans and Administrative Settlements.** A small percentage of taxpayers neither pay the total amount of self-assessed tax due when they file their returns or as a result of a subsequent audit assessment. If, after review and investigation of the taxpayer’s financial information, the tax administration determines that it is in the best interests of the government, an installment payment plan can be granted. This is typically only done if the taxpayer remains current in all other tax obligations. Use of this collection tool avoids taking enforced collection action which could result in putting the taxpayer out of business. If permitted by law, additional administrative settlements can be pursued to reduce the taxpayer’s assessed liability.
- **Tax Amnesties.** In order to move taxpayers from the shadow economy onto the tax rolls, or to bring registered but non-compliant taxpayers current in their tax obligations a tax amnesty program can be considered. Depending on the nature of the amnesty program, taxpayers may be forgiven for past non-filing or non-payment of taxes, have all penalties and/or interest waived, or be exempted from prosecution for past tax crimes. Experience has shown that amnesty programs are most effective if well publicized, not repeated, and followed by strict enforcement measures for taxpayers who don’t take advantage of the program and remain non-compliant. Additional information on tax amnesties including a partial list of countries where amnesties have been used can be found in Annex 14.

Hungary and Latvia are examples of two countries that have taken steps to improve conditions for small and medium taxpayers as well as the taxpaying public in general. They have adopted almost all of the above referenced measures as well as the best practices described earlier in this paper. Additional information on Hungary’s experience can be found in Annexes 15 and 16. Two other countries making great strides in this direction are Rwanda and Uganda. The previously referenced Corporate Business Plans for Latvia, Rwanda, and Uganda evidence their progress.

## Summary

122. The successful modernization of the tax administration in a developing country is a long term process. The opportunities to achieve success are facilitated by an environment which embraces the rule of law, a political commitment to public sector reform, a political commitment to combat corruption, and rational tax policies. Given this environment; adequate resources; an information management system based on a unique TIN; technical assistance by experienced consultants; and a reasonable timeframe, success will be achieved. It should be noted, however, that tax administration reform will achieve only marginal success unless it is undertaken as an integrated process. Support business processes must also be in place. The need for an overall implementation plan and process cannot be overemphasized.

123. A well functioning tax administration, perceived as treating all taxpayers fairly and with respect, and concerned with collecting only the proper amount of tax, will go a long way towards achieving the goal of voluntary compliance which benefits everyone. While no one enjoys paying taxes, seeing others escaping the tax net while you are attempting to pay your fair share is even less appealing. In the end, SMEs along with other taxpayers benefit from a well functioning tax administration system.

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