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# USAID'S LEADERSHIP IN PUBLIC FINANCIAL MANAGEMENT

## **Detailed Guidelines for Improved Tax Administration in Latin America and the Caribbean**

### **Chapter 7. Filing and Payment**

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# Detailed Guidelines for Improved Tax Administration in Latin America and the Caribbean

## Chapter 7. Filing and Payment

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## List of Acronyms and Abbreviations

Acronym	Definition
CFO	Chief Financial Officer
CIAT	Inter-American Center of Tax Administrations
CIPRO	Companies and Intellectual Property Registration Office (South Africa)
CRA	Canada Revenue Agency
GST	Goods and services tax (Canada)
HR	Human resources
IRS	Internal Revenue Service (United States)
IT	Information Technology
LAC	Latin America and the Caribbean
LTO	Large Taxpayer Office
OCR	Optical character recognition
OECD	Organisation for Economic Co-operation and Development
PAYE	Pay as you earn
SARS	South African Revenue Service
SME	Small and medium-sized enterprises
TIN	Taxpayer identification number
TIPP	Tax installment pre-payment plan
VAT	Value added tax

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# Chapter 7. Filing and Payment

This chapter is intended as a tax administrator's guide to filing and payments and provides observations on some of the more frequently encountered problems and insight on approaches to resolving them. Filing and payment processing is not an end on its own, but is an essential part of the chain of events that results in obtaining and storing information that is used for other functions, such as collections, audit, revenue reports, and tax analysis.

## 7.1. Leading Practice

With respect to filing and payment, the tax administration has two primary concerns. First, taxpayer filings and payments require significant processing and must be done efficiently, at minimal cost, so that the tax administration can use its resources for other activities. Second, the tax administration must work to ensure that taxpayers comply with filing and payment requirements. Since filing and payment are the two primary obligations of taxpayers, compliance, including appropriate sanctions when a taxpayer fails to comply, is addressed at length in this chapter.

Throughout this chapter, a "compliant" taxpayer is one that:

1. Registers for tax purposes;
2. Files tax returns, including information returns, by the date required in the law;
3. Correctly reports tax liabilities; and
4. Pays the tax by the date required in the law.

The requirement to make tax payments based on some form of liability has been a fact of life since before biblical times. The administration of taxes slowly evolved over the past couple of millennia, but the pace quickened during the latter part of the 20<sup>th</sup> century through the introduction of self-assessment, improvements in management and organizational structures, an improved legal framework, and, most importantly, the introduction of better working tools – namely, automation, coupled with advances in communication and banking. With these changes tax administrations have been able to both rapidly process returns and identify non-compliant taxpayers.

### 7.1.1. Self-Assessment

Before beginning a discussion on filing returns and how to best gain compliance, a brief discussion concerning the main underpinning principle of modern tax policy and tax administration is worthwhile. Most modern tax administrations are based on a self-assessment system<sup>1</sup>. In recent decades, there were major changes that tax administrations had to cope with: the general population was growing, economies were changing, small and medium-sized taxpayers were becoming more prolific, and tax law was becoming more complex.

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<sup>1</sup> Self-assessment is also briefly discussed in Chapter 3.

Tax administrations found they were trying to cope with organizational structures and work methods that were developed when the tax legislation was not as complex during an era when they were dealing with much smaller workloads. Under these old methods of administration, a tax officer would often be assigned to specific taxpayers. This tax officer was responsible for the all-inclusive administration of the tax law as it pertained to "his/her" group of assigned taxpayers. This responsibility included the delivery of tax returns to these taxpayers, responding to taxpayer questions, mathematical verification of tax liability, collection of accounts in arrears, obtaining returns from non-compliant taxpayers, and auditing their assigned group of taxpayers. The strategy of assigning specific taxpayers to specific tax officers and involving these officers in preparing or checking each tax return at the time it was submitted, plus all other administrative activities, necessitated constantly increasing staff levels as the number of taxpayers increased. This became impractical, as most tax administrations did not have sufficient funds to continually grow, and caused tax administrations to instead reduce the time spent on enforcement activities.

It became evident that the processes surrounding tax return filing, tax payments, and the collection of tax arrears required significant changes, with or without the existence of a self-assessment system. To a large extent, administrative pressures and progressive management thinking led to the concept that the taxpayer ultimately knows more about their tax affairs than anyone else, including the tax officer. If a taxpayer is provided clear information, simple procedures, and sufficient encouragement, then he/she can calculate and remit the correct amount of tax without assistance from either the tax administrator or commercial tax preparers.

This is the **self-assessment system** – taxpayers are provided with information that gives them sufficient understanding of their tax obligations and rights and enables them to calculate their own tax liabilities, to complete their tax returns, and to remit the correct amount of tax at the time required by the law. There is no intervention by a tax official in this process to check that each return is correct. Although the tax administration reserves the right to audit returns, it does so selectively and at a later stage.

Self-assessment has become one of the basic strategies that permit tax administrations to effectively administer the country's tax laws. It places more responsibility on the taxpayer, because each tax return must now be prepared without the direct assistance and confirmation of a tax administrator. A self-assessment system is much more efficient for the taxpayers, as well as for tax administrators. Taxpayers no longer have to spend hours in long lines each month waiting to have "their" tax administrator accept the tax return, or come back repeatedly if their tax administrator is unavailable. Tax administrations can introduce greater specialization in their operations by organizing staff to specialize in particular functions. This organizational change allows taxpayers to direct questions to a team of tax information experts, without having to locate or wait for their particular tax administrator.

Self-assessment is a system within which taxpayers have a duty to:

- Report the facts on which their liability for tax is computed;
- Compute their liability for tax;
- File a tax return showing the result of that computation; and

- Pay the tax (usually the filing date and payment dates coincide) owed at the time of filing.

As discussed in this and other chapters, the general conditions necessary for a properly functioning self-assessment system are:

- Stable tax law;
- Taxpayer services;
- Simple filing and payment procedures;
- Effective non-compliance detection and enforcement;
- Selective risk-based audit programs;
- Fairly applied sanctions; and
- Fair and timely dispute resolution.

### 7.1.2. Legal Framework

Modern tax administrations have the responsibility to collect the proper amount of tax at the least cost. This begins with the legal framework. It is important that the legal provisions contain the tools to require taxpayers to correctly file returns and remit the proper amount. Tax laws should contain provisions for:

- Who is required to file a return;
- The time at which a return is required to be filed;
- How returns can be amended;
- Where the return must be filed;
- What information must be provided (form<sup>2</sup>);
- Authority to demand a return that has not been filed;
- What tax is to be paid, whom it is payable to, and where it is to be paid; and
- Appropriate sanctions that will be applied where a taxpayer fails to comply.

As discussed in Chapter 3, some tax administrations place the general rules relating to returns (e.g., who is required to sign the return and other procedural matters) in a general tax administration law and leave a separate, tax-specific law to determine who is required to file the return and the filing deadline. In other countries, the substantive law may be self-contained, having all the necessary provisions for its administration within the one law for a specific tax. Still another approach is for all the (national) tax laws to be organized into a single law or tax code. In keeping with the principles of self-assessment and making it as easy as possible for the taxpayer to comply, consolidating all the provisions into as few laws as possible is the preferred approach. A tax code, being the ideal situation, removes the potential for conflicts and confusion that can develop when provisions are scattered across more than one law.

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<sup>2</sup> Forms, depending on the country's legal system may be: 1) required to form part of the primary law as a schedule that can only be amended through the legislative process; 2) prescribed by subordinate legislation such as by regulation; 3) may be prescribed by the tax administration with appropriate notice being published. This latter system of administratively determining the content of forms makes it easier to amend forms when necessary.



The requirement to file the tax return generally specifies that all persons who are taxpayers are required to file a return and remit the tax imposed by that law to the government. The law broadly defines who is a taxpayer and requires that they file a return, including, for example, anyone who exceeds a certain threshold or is engaged in a certain type of activity, regardless of whether they had come forward and registered or not.<sup>3</sup> This construction eliminates the need for additional provisions that describe the need for filing returns and paying tax by taxpayers, who have failed to register.

In addition to the requirement to file a return, there should not be confusion about the requirement to sign a return. In the absence of an e-file provision in the tax law or an all-encompassing e-commerce law, tax administrations require original signatures signed in ink. In most tax jurisdictions, the general assumption is that the signature on the return is presumed to be valid unless the person claims the signature was not theirs and proves it. In many jurisdictions, the law or regulations provide for tax preparers to sign original returns in a special block on the return that indicates it was prepared by a person who was paid to prepare the return. Of particular importance are the provisions relating to corporations. The legal norm is that returns are signed by an officer of the company, which would normally include the president, vice president, treasurer, chief accountant, or any other person, who is authorized to sign. Similar to other returns, a paid preparer, such as an accounting firm, can sign the returns for a corporation. It is important to note that, although the preparer may have been engaged by the corporation to file the return, unless there is a valid designation authorizing the tax administration to communicate with the preparer, such communication would be prohibited under the secrecy provisions of most tax laws.<sup>4</sup>

Notable and typical shortcomings to providing a sound legal basis to file tax returns and remit the required amount of tax in some countries include:

- The law requires a return to be filed, but fails to specify the form. Countries should require that forms be published in one of the following ways: (a) as part of the substantive law, which requires approval by the legislature; (b) as part of a regulation, which, within the regulatory process, may or may not require approval by the legislature depending on the legal system; or (c) as part of an administrative action, which only requires approval by the head of the tax administration and some form of public notification. Failing to specify the form can have the unintended result that a letter or anything submitted has to be considered a return. Such submissions are difficult to computerize. In some jurisdictions, the failure to specify the return form renders the requirement to submit a return void until such time a form is specified;
- Requiring a return to be filed, but failing to specify where the return is filed such that returns submitted to any tax office, including the most remote one, are acceptable;

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<sup>3</sup> In the case of VAT, it is common for the law to state that all registered persons and *those required to be registered* are required file a return and remit the tax.

<sup>4</sup> There are other instances where returns are submitted on behalf of a taxpayer. These include the final income tax return filed by the trustee on behalf of a deceased person and, in the case of financial insolvency, a return filed by a receiver or trustee in bankruptcy. In these situations, the returns would be accepted when accompanied by proof that the signatory has the legal capacity to file the return.

- Returns are considered filed if postmarked on the due date, even though an inefficient postal system can take several days or even weeks to get the return to the addressee; or
- Provisions for electronic filing of returns are either non-existent or are outdated due to technological advances.

The following few subsections describe specific areas of the legal framework that are of paramount importance to filing and payment and deserve additional attention: tax policy simplification, form design, withholding taxes, and sanctions.

### 7.1.3. Tax Policy Simplification

Tax administrations exist for the purpose of ensuring taxpayers' compliance with the tax laws and the exercise of good tax policy choices by the political leadership directly impacts tax administration and compliance. This said, "tax administration is tax policy" – a statement often attributed to Milka Casanegra de Jantscher, head of the IMF Fiscal Policy Division in the 1980s. She had concluded that, however finely tuned the design of the tax policy might be, it is the manner of interpretation and implementation of the law by the tax administration that counts. The tax laws can contain a large amount of complexity and, if combined with the tax administration not having appropriate staff to interpret and implement the law, cause the actual burden of the tax to be very different from the original objective. Complexity in the law also leaves latitude for "interpretation," and, hence, rent-seeking can easily take hold to supplement what are perceived to be low salaries in many tax administrations.

It is not a surprise that increases in the complexity of a tax causes more persons to use the services of tax practitioners, but, interestingly, the average level of non-compliance is higher for tax returns prepared by persons who were paid for this assistance.<sup>5</sup>

### 7.1.4. Form Design – An Important Consideration

The tax system starts with the tax return. This is often an overlooked, yet critical element in the process of encouraging tax compliance. There are some basic guidelines that contribute to overall compliance: (a) the return should be kept as simple and self-explanatory as possible; (b) it should present a series of logical steps to calculate the amount of tax owed for the tax period; (c) it must provide sufficient information in a logical format for the tax administration to be able to verify the proper calculation of the taxpayer's tax liability and be able to run various background validation tests; (d) where necessary, a guide to properly completing the return should also be produced in an effort to reduce taxpayer errors,<sup>6</sup> which will reduce processing costs and time and assist with efforts to rapidly identify non-compliance; and (e) the professional appearance is as important as the design.

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<sup>5</sup> Alm (1999), p. 21.

<sup>6</sup> For example, the tax administration of India began publishing, in all indigenous languages, a pamphlet entitled *How to Compute Your Taxable Income*. Two years after the first publication, computational mistakes had dropped from about 22 percent to 3.5 percent. This reduction in computational errors produced savings in administrative costs.

Designing forms is a specialized field that is beyond the scope of this document. There are, however, a few basic guidelines:

- All forms should have a consistent look as part of a corporate identity, and certain information blocks should be standardized;
- Information requested should be consistent across the whole series of tax returns and other documents. For example, the taxpayer name, address, and taxpayer identification number (TIN) should be consistent across all forms in the same position, typeface, spacing, *etc.* This presents a professional appearance;
- All forms should have a form number and a revision date;
- Form making software is available and should be used to prepare all forms in order to provide a professional appearance.<sup>7</sup> A quick internet search will result in a multitude of software that can build professional looking forms;
- If forms are completed by hand, the response areas should provide sufficient space to accommodate a large script;
- Lines and cells in forms should be numbered. This makes references in instructions easy to follow and navigation in the form simpler. In addition, when cells in paper forms are numbered, data entry becomes simpler, as the data entry operator can simply type the cell number and the value submitted by the taxpayer for that particular cell;
- In forms that will be processed manually, the tax administration should consider including a check digit<sup>8</sup> in the line number as in the example below. The operator will have to enter the number of the cell, the value submitted by the taxpayer, and the check digit. This process minimizes a frequent error, where operators capture cell number and values of a line above or below the actual line that is being processed;
- Questions and response areas should follow in a logical progression;
- Statutory references should be totally absent, or should be included as footnotes to any explanatory notes or instructions;
- All forms should be on a standardized paper size, i.e., A4 or Letter;
- All forms that are available to the public should be available online through the tax administration website, either for download or to be filled online and submitted;
- Clear instructions with examples should be provided;
- In cases where minimal information is captured and a large amount of forms need to be processed, the tax administration should consider the use of forms that can be processed using optical character recognition (OCR) technology. OCR technology has evolved to become a reliable data capture technology. OCR technology should be limited to forms that contain mostly numeric information. It can be considered an expensive solution since special equipment is required to capture process and review forms;

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<sup>7</sup> One of the industry standards is Adobe, due to its ability to build forms that can be completed online and complemented by the other services that Adobe can offer.

<sup>8</sup> This digit is computed from the remaining digits entered. If the system computation results in a check digit that is different than the one included in the line, then there is an error in the entry.

- Some tax administrations have implemented pre-printed forms, where some information, mainly identification information, is printed on forms that are sent to taxpayers. This process relies on a well-established mailing infrastructure; and
- With the increase in the amount of electronic data being collected for audit and other purposes, tax administrations have the ability to pre-populate tax forms for taxpayers in some cases. For example, in the case of income tax withholding for employees, the tax administration requires companies to report the withheld amount for each employee. This information can be used at the end of the year to prepare a "suggested" or pre-populated individual income tax return that the taxpayer can access on the internet and modify or simply submit with his/her concurrence.<sup>9</sup> Similarly, the use of electronic invoices and information from Customs facilitates the preparation of a pre-populated form for the monthly VAT filing.

**Figure 7.1. Sample section of a VAT form<sup>10</sup>**

6	Capital Gains	(attach schedule)	+	<b>100</b>		9
7	Rental Income	(attach schedule)	+	<b>105</b>		4
8	Interest Income		+	<b>110</b>		8
9	Other Revenues	(attach schedule)	+	<b>115</b>		3

### 7.1.5. Withholding Tax

An appropriate legal framework should ensure that the number of taxpayers is reasonable when considering the tax administration's budget, staffing levels, and infrastructure. This means that, for example, when designing a VAT, the threshold requiring registration should keep the number of estimated taxpayers within the bounds of the tax administration's capability. It can also mean that the number of persons required to file a personal income tax return should be kept small by setting a minimum taxable income, below which persons are exempted from filing a return. In addition, where a person's sole source of income is subject to PAYE (pay-as-you-earn) and tax is withheld by the employer, this can be treated as a final tax whereby the employee is not required to file a return. This rationale for withholding goes to economies of scale, where the tax administration has to deal with a considerably smaller number of larger remitters of PAYE – employers – who have the sophisticated record-keeping and accounting systems to simplify the process of tax remittance and information reporting. Source withholding increases tax compliance as long as the tax administration closely monitors the withholding agent for compliance. This is easier with a single employer than with many employees. Withholding taxes also act as a safeguard, ensuring that some tax is remitted even when the statutory bearer (e.g., the employee) of the tax fails to file a return or otherwise disregards their tax obligations. A properly

<sup>9</sup> According to CIAT, Argentina, Chile, the Dominican Republic, Mexico, and Peru already have pre-printed or pre-populated returns. The study notes that the number of tax administrations that implement these will grow as the service becomes better known and improves in quality, which requires working continuously to improve the updating and accuracy of the tax information (Inter-American Center of Tax Administrations (CIAT) et al. (2012), p. 53.).

<sup>10</sup> Note that each data cell is numbered and a check digit for data entry purposes has been added at the right hand side of the cell.

functioning withholding system reduces the cost of administration: there are less files / returns to deal with, requiring less staff, less physical space and other infrastructure, and less personal interaction with small taxpayers.

In the OECD countries,<sup>11</sup> income-related taxes, for example, account for approximately 62 percent of total tax revenue.

- 28 of 30 OECD countries apply withholding taxes on employment income; and
- 23 of 30 OECD countries routinely apply withholding to payments of dividend and interest income.

Given the large contribution of these taxes to a government's revenue, it is worthwhile to design administrative mechanisms such as withholding tax at source to ensure compliance.

When designing a withholding regime, electronic reporting should be a requirement for larger businesses and government, while web-based reporting solutions should be developed for smaller taxpayers. This may involve upgrading the tax administration's information technology (IT) systems and working with taxpayers to develop an appropriate interface between taxpayer systems and the reporting requirements. Moreover, Scandinavian countries are piloting the use of information reports submitted for withholding to pre-fill the tax returns for some individuals. The concept is that these pre-filled tax returns will eliminate most of the effort required by taxpayers to complete their annual tax returns. By doing this, the compliance rate should increase.

The below table is illustrative of some of the withholding and reporting systems in use in selected OECD countries.

**Figure 7.2. Withholding and information reporting regimes of selected OECD countries<sup>12</sup>**

Country	Name of Regime	Nature of regime	Industries targeted	Year begun
Canada	Contract Payments Reporting System (CPRS)	Reporting only	Construction & all goods & services provided on a contractual basis to Federal Government Bodies	1999
Ireland	Relevant Contracts Tax (RCT)	Reporting (withholding sanction)	Construction, meat processing & forestry	1970
	Professional Services Withholding Tax (PSWT)	Withholding & reporting	Professional services (as defined)	1987
	Third Party Returns (TPR)	Reporting only	Very broad coverage prescribed in law	1992
Japan	Statutory Withholding and Reporting (SWR)	Withholding & reporting	Specific categories of remuneration & fees prescribed in laws (not captured by 'employment')	1899

<sup>11</sup> OECD (August 2009), p. 6.

<sup>12</sup> Ibid., p. 14.

Country	Name of Regime	Nature of regime	Industries targeted	Year begun
			income)	
New Zealand	Schedular Payments (SCH)	Withholding & reporting	Very broad coverage prescribed in law	1979
Norway	Withholding tax-fishermen (WTF)	Withholding & reporting	Fishing	1956
United Kingdom	Construction Industry Scheme (CIS)	Withholding & reporting	Construction	1972
United States	Information Returns Program (IRP) and backup withholding	Reporting & withholding	Very broad coverage prescribed in law	1954, 1984, 2011

Although withholding reduces the costs to the administration, it imposes additional costs on businesses that should be considered when deciding on a withholding regime. These costs include:

- Training costs for the human resources (HR) and payroll department, as well as the costs of making those who will have PAYE deducted informed about how the system works;
- The cost of obtaining information required from payees;
- The costs of adjusting the payroll/accounting system and maintaining records for possible future audit verification;
- Accounting for any taxes that must be withheld from payments made;
- Preparing information returns for the tax administration;
- The costs of preparing PAYE information slips on amounts withheld;
- The costs associated with inquiries/ audits by the tax administration; and
- Personnel costs.

Finally, there are new costs that the tax administration should bear, including:

- Preparation of guides and other explanatory materials;
- Enhancements to the IT system;
- Processing costs related to the additional workload for returns and payments;
- Additional staff for dealing with information requests; and
- Enforcement costs to deal with the additional workload for non-filers, stop-filers and failure to pay cases for PAYE.

#### 7.1.6. Sanctions

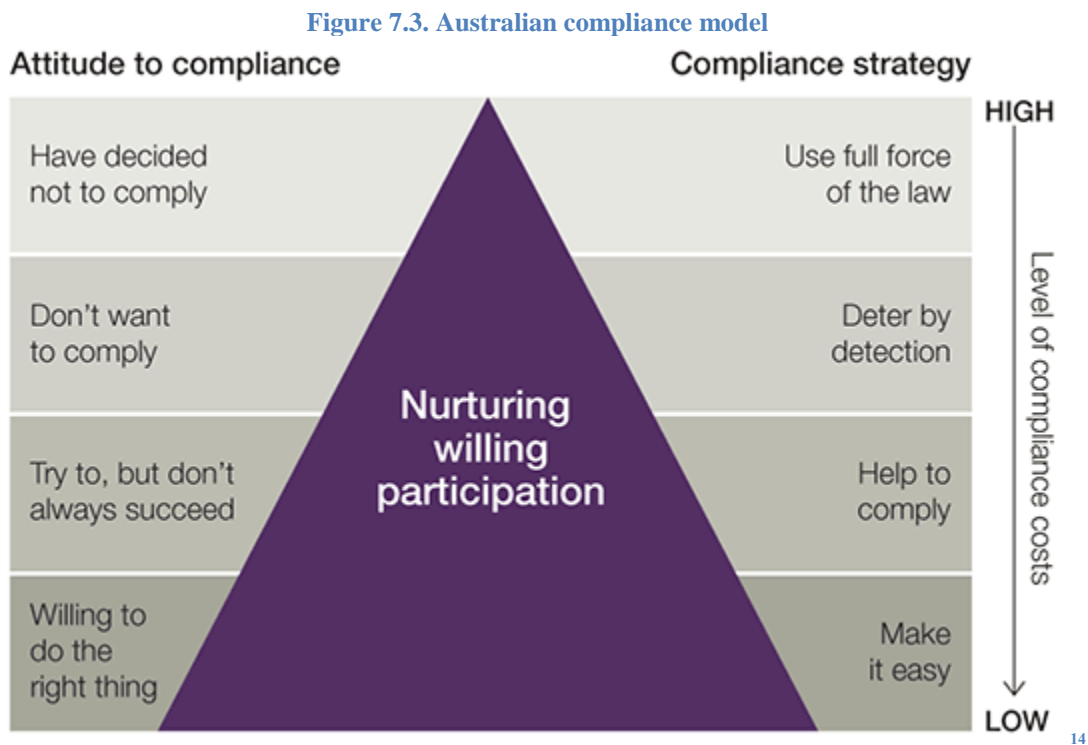
Effective penal provisions in the legal framework are necessary to encourage taxpayers to comply, and there is a considerable body of research into penalties for non-compliance. It should be noted, first, that not all taxpayers deliberately set out to be non-compliant. There are unintended errors and honest mistakes, and sometimes taxpayers simply do not understand how the law applies. As a result, non-compliance can be divided into two categories. The first category comprises taxpayers who are non-compliant, but would probably comply voluntarily if conditions were different. For example:

- They lack sufficient information on how to comply;
- The effort to be compliant is too expensive. That is, they cannot spare the time or afford an accountant; or
- It is too difficult to comply. Many hours are spent in a queue waiting for a tax official to accept the return.

The second category consists of the taxpayers that willfully decide not to comply. These taxpayers may:

- Make an economic decision to evade paying tax, where the costs and risk of detection are less than the perceived benefit of non-compliance;
- Fundamentally disagree with paying tax. They may disagree with the government's policies; or
- Avoid paying tax through overly aggressive tax planning.<sup>13</sup>

The below diagram illustrates the results of research into tax compliance by the Australian Tax Office. Similar to all countries there are a very small number of taxpayers who for a variety of reasons make a conscious decision to be non-compliant. This small group requires the tax administration to expend considerable resources and apply the law to its fullest extent in order to obtain compliance. This is contrasted by the large majority of taxpayers who are generally compliant where it may only be necessary for the tax administration to send the taxpayer a low-cost reminder notice to assist them in complying.



<sup>13</sup> Aggressive tax planning consists in taking advantage of the technicalities of a tax system or of mismatches between two or more tax systems for the purpose of reducing tax liability.

The taxpayer's perception of the risk of being detected, combined with the taxpayer's perception whether the sanction will actually be imposed, is important. For example, the government willingness to impose sanctions and pursue cases in the courts, where necessary, is a factor in attaining compliance.<sup>15</sup> Thus, when taxpayers know or perceive that their likelihood of being prosecuted in court is negligible, these sanctions become ineffective. The situation can worsen if taxpayers believe that non-compliance is relatively common and goes unpunished. An attitude of "everyone does it, so I will too" may develop, or what is sometimes referred to as "the crowd mentality" may emerge, resulting in the quasi- legitimization of non-compliance. This type of non-compliance is difficult to turn around.

When designing a sanction scheme, there are other factors to consider.

- Although the rationale for sanctions may seem obvious, governments should not lose sight of the fact that their purpose is to correct or deter non-compliance. Financial penalties should not be viewed as an important source of revenue. It is inadvisable, for example, to split a portion of the penalties with the revenue administration, as this will become an incentive to apply penalties as frequently as possible. Dependence on penalty revenue can also be a source of discontent and resentment by taxpayers, and the sanctions can lose their deterrent effect.
- Including imprisonment in the sanctions as an alternative to a monetary penalty can have fiscal implications for governments, and there may also be legal limitations on its use. Prison terms cost the government for facilities, incremental costs for each prisoner, trial costs, *etc.*, and may result in increased expenditures that affect the budget. In addition, the ability to use imprisonment as a sanction is often reserved for the most severe economic crime of criminal fraud. Including imprisonment for failing to simply file a tax return and pay taxes does not fit the scheme of the sanction being proportionate with the offense.
- Financial penalties may be inconsequential to some taxpayers, such as those with a high overall net worth or, conversely, those that lack the resources to pay the penalty. In other situations, where there is inflation, the effect of the sanction could be nullified if payment can legally be delayed long enough. Even well-crafted financial penalties, such as those that are proportionate to the amount due or that increase for subsequent offenses, may still be ineffective. In this circumstance, possibly imprisonment as an alternative penalty would be more effective or even the temporary closure of the business could be considered but their use would be under exceptional circumstances.<sup>16</sup>
- The effect of sanctions being compounded is an important consideration. Sanctions that continue to compound into an exorbitant amount that cannot be paid could be viewed as unjust and confiscatory. Some countries have been accused of using the tax system and these severe sanctions to silence their opposition, or to sell the assets of a successful business at "fire sale" prices to their friends. If sanctions are enforced largely against the less powerful, and the

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<sup>14</sup> Australian Taxation Office, Compliance Program 2011-12, <http://www.ato.gov.au/corporate/content.aspx?menuid=0&doc=/content/00284023.htm&page=5&H5>.

<sup>15</sup> Examples are discussed in Chapter 9.

<sup>16</sup> Financial penalties should be "appropriate," which cannot easily be described in legislation and the purpose of the paragraph above is to note some of the potential pitfalls. In addition, imprisonment should likely remain reserved for offences such as fraud, as discussed in Chapter 9.



wealthy or currently connected persons are seen to be above the reach of the law, then it is reasonable that the public's perception of justice is weakened. This also has the potential to lessen tax compliance. Thus compounding sanctions should be capped at a reasonable amount that can be paid.

While they may be well-intentioned when initially drafted, severe sanctions provide the possibility for abuse. This is also particularly important where there is corruption in the tax administration. Situations can quickly develop where administrative powers are selectively applied by corrupt tax officials to extract additional personal income. The general guidance when considering a sanctions scheme, and its accompanying administrative guidelines, would be to deal with non-compliance by imposing moderate sanctions more frequently than by creating an elaborate scheme of sanctions containing some provisions that are so severe that they are intended to be rarely applied.

Even well-intentioned administrative action to reserve the sanction for punishing presumably rare and severe cases of non-compliance can also be perceived as arbitrary. Thus, when designing sanctions as a deterrent, it is better to ensure that they are relatively light and have programs to detect non-compliance rapidly, as opposed to having severe sanctions that are applied infrequently. If severe sanctions must be included (often as a result of religion and history), they should be subject to oversight and an independent appeal process.

The above considerations are important when designing sanctions for non-compliance with the law. In particular, in cases of delayed payment, charging interest on penalties for non-compliance serves to protect the real value of the government's revenue, and the penalty itself is meant to discourage non-compliance.

### *Interest*

Late payments should automatically be assessed interest since interest reflects the time value of money. The application of interest should never be waived. The common practice is for interest to accrue at a market rate rather than some arbitrary rate that is either too low to fairly reflect the actual cost of the use of unpaid taxes by the taxpayer, or so much higher than market rates that it becomes a penalty. The rate of interest is typically set by regulation or some other mechanism where it can be periodically adjusted without requiring legislative approval for each change. The most common method of determining the rate is by reference to the Central Bank rate plus a certain percentage to approximate the rate of interest a business would be charged if it borrowed money from a commercial lender. In determining the surcharge on the Central Bank rate, it is presumed that a defaulting taxpayer would be charged a higher rate by a commercial lender than it would charge to one of its best customers. This higher rate further discourages defaulting taxpayers from cheaply "borrowing" from the government.

Bank rates can change frequently, so to avoid administrative costs that would result if the rate were to change every few days, it is more convenient to establish specific dates on which the rate is set. Some countries may specify in the tax law that the Central Bank rate on the first day of each calendar quarter will serve as the base rate (plus pre-determined surcharge) to be charged on late tax payments for that

calendar quarter. Other countries adjust their rate less frequently, but at a minimum the rate should be adjusted annually to account for changing global economic conditions.

### *Penalty*

The purpose of imposing a penalty for the failure to file a return or make a payment is to deter non-compliance. Usually, there are separate penalties for failure to file a tax return and failure to pay tax on time, as each of these acts is a separate form of non-compliance. There are some fundamental issues to consider when determining the size of a penalty. First, the amount of the penalty should be fair. For example, the tax administration must consider whether the penalty for the failure to file an information return should be equal to the penalty for failing to file an annual income tax return or a monthly VAT return.

The penalty should have a reasonable chance of being paid. For example, if a taxpayer is struggling to pay the tax, it may not be reasonable that a penalty for failure to pay should continue to compound to become ten times the original amount owing. If an imposing a large penalty due to compounding has no reasonable chance of being collected, it should not be imposed. Large penalties can distort the government's potential revenue and have an impact on government budgets. Large penalties are likely to become uncollectible and, thus, will need to be written-off at a later date.

As previously mentioned, penalties are often structured to take into account varying degrees of culpability. For example, tax laws generally contain considerably more severe sanctions for cases of fraud, such as financial penalties that are twice as large as normal. Where the payment is late, the usual approach is to calculate the penalty as a percentage of the amount of tax that is due. In this manner, the penalty is proportionate to the amount of tax that is not paid. Penalties of this type can, however, become excessive, and ultimately uncollectible, if the taxpayer does not pay quickly and the penalty amount continues to grow over time. As a result, the common practice is to limit the penalty to a maximum, thus retaining a reasonable chance the penalty imposed can be collected.

A sample penalty regime could be: a penalty for the first month of 5 percent of the unpaid amount, which would decrease to 2 percent for each subsequent month up to a maximum penalty of 25 percent or 50 percent for deliberate underpayment. The penalty is further increased by an additional 10 percent (of the amount due) in the case of negligence (which is defined as any underpayment greater than 30 percent of the amount owed). In cases where the taxpayer is found guilty of fraud by the court, the civil penalty is double the amount that would have been applied if the taxpayer had been negligent, but a criminal sanction may also be applied such as an additional financial penalty or even imprisonment. It is also worth noting that in cases where the late payment is a trivial amount, some countries do not apply a penalty, recognizing that small amounts cost more to collect than the amount owed. In Canada, penalties on amounts of less than one dollar are not applied.

Failure to file a tax return is generally subject to a fixed penalty, rather than a proportion of the amount due. A proportional penalty for late filing leads to difficulties in situations where only a small amount of tax is due, as the small resultant penalty does not have a deterrent effect. Another difficulty with the

proportional approach is that there would be no penalty in cases of "nil" returns and information returns. Furthermore, filing a tax return is a key document that is relied upon by tax administrations for determining other actions, such as risk analysis, audit selection, and statistical analysis of the tax base. For these reasons, a specified minimum sanction that applies in all cases regardless of the amount of tax that may be declared is preferable.

As a final note concerning the size of the penalty, some countries that are experiencing relatively high inflation have found it useful to index the penalty amounts for inflation. Penalties could be expressed in terms of generic penalty units in the legislation, with the value of the penalty unit determined by a regulation at specified intervals.

### *Special Circumstances - Personal Liability for Penalty*

Another issue that arises is with respect to legal persons. An example would be a company that is required to file and remit VAT but has insufficient funds to meet all the company obligations. The Chief Financial Officer (CFO) directs that salaries and trade accounts are paid instead of remitting the VAT. In this situation, the company, as the taxpayer, would incur both interest and the penalty for failure to pay, but the physical person (CFO) who is responsible for the company's tax position is not subjected to any sanction. Not remitting VAT is particularly important, since in most countries the VAT is collected by the taxpayer on behalf of the government and this money is legally regarded as "trust funds." In this example, the person who suffers the penalty is the owner of the company and not the physical person who was responsible. Some countries have tried to address this situation by including a penalty for the "responsible physical person." Such a penalty provision is usually restricted to specified circumstances, such as in the United States where the penalty applies only in the case of failure to withhold the appropriate amount of taxes on payments to third parties and on failure to remit employee withholding (PAYE). In this situation, the legal person and the "responsible physical person" are considered to be jointly and severally liable for a penalty that is equal to the amount of tax withheld but not remitted or the amount of tax that is underpaid to a third party.

### *Rapid Detection of Stop-Filers*

The more rapidly non-compliance can be detected the more effective the sanction will be as a deterrent. It is human nature for people to discuss, at least in broad terms, how the tax system has treated them or to sometimes boast about how they got away with something. Thus, if non-compliance is detected quickly and sanctions are applied, others in the community will become aware of the efficiency in detecting non-compliance through word of mouth. Identifying non-compliance quickly also affects the taxpayer's subsequent behavior. For example, if a taxpayer fails to file a monthly VAT return and they are notified shortly after the due date that it was not received and an automatic penalty has been applied, this has a higher probability of correcting their behavior for the next monthly VAT return. Secondly, if the failure to file the return was not an honest error and it was not dealt with quickly, there is a greater likelihood that the taxpayer's non-compliant behavior could be repeated, testing other taxes the next time, in addition to repeating the original VAT non-compliance.

Similarly, it is also human nature to dislike paying a penalty, no matter how small. People may accept a penalty more easily if the rules are clear and known, but they will still take action to avoid being penalized. For example, when a parked vehicle on a public street remains past the allotted metered time, people are accepting of the parking ticket as they know the consequence. There are usually many stories circulating about the efficiency of the police in ticketing vehicles, so they have the perception of a high probability of receiving a parking ticket. As a result, people will hurry back to their vehicle to avoid receiving a ticket. The same generality applies to taxes.

The most important administrative action that can be taken is to design processes and procedures that will assist in the rapid detection of non-compliance when it occurs, the application of automatic sanctions, and swift notification of the taxpayer. The simplest method of applying a sanction, in the case of failure to remit tax when due, is to automatically apply a percentage calculation to the amount of tax due but unpaid. To introduce an element of fairness into the application of automatically applied sanctions, in situations where the taxpayer can prove that they could not comply due to circumstances that were beyond their control or some other defined reason, the tax administration would, following defined and published guidelines, have the ability to remit the amount of penalty that had been automatically applied. This is a proven, effective method of deterring subsequent non-compliance.

As a component of clear and understandable tax laws, sanctions should be uniformly the same across the various laws, if they are not contained in a single statute. In this manner, taxpayers can understand sanctions more easily. Furthermore, beyond simplifying the law, uniformity also makes it easier for the tax administration to apply sanctions. Finally, taxpayers should not be faced with the imposition of multiple penalties for the same offense, nor should there be non-compliant behavior for which there are no penalties.

### *Frequent Problems with Sanctions*

Some of the more common problems with sanctions can be:

- Penalties that are specific amounts in the substantive law. Over time, with inflation, the deterrent effect of the penalty is lessened to the point where it becomes a meaningless amount. Legislators are sometimes hesitant to revise these amounts, as revisions to a tax law must usually follow the legislative process which can be time consuming. As part of this legislative process, there is the risk that penalties would be subject to possible debate where proposed changes could be altered or even rejected. Some countries have created the application of penalty units, with the amount of a unit being determined by a regulation, Ministerial decree, or some other mechanism that does not require returning to the legislature. The rationale being that a regulation is easier and quicker to change.
- Laws that impose penalties regardless of the amount can unintentionally create small residual amounts on a taxpayer account that must be collected. These small amounts can become an administrative headache to collect, aggravating the taxpayer, and often costing more to notify the taxpayer and collect that the original amount. For this reason, tax laws often have a de minimis amount, below which interest and penalty is not applied.

- Overly complex sanctions that try to define various circumstances with a variation of the sanction to each circumstance. While the original intent is to provide a graduated system of sanctions depending on severity, these complexities can lead to a lack of clarity, issues of interpretation, and, ultimately, disputes.
- Compounding can initially be a compelling reason to settle tax arrears, but, in the absence of an upper limitation, it becomes an amount that cannot be reasonably repaid.
- Sanctions that are overly severe as to result in the business ultimately being closed and its assets sold under the arrears collections provisions of the law. Severe sanctions can be abused as a negotiation point to extort bribes or as a means to silence political adversaries.

### *Partial Payments*

Taxpayers often misunderstand how their payments will be applied to any amounts that they may owe, including if the amount paid is insufficient to cover current arrears. In most countries, partial payments are applied first to penalties and interest in the order in which the penalties and interest became payable, and second, to taxes, fees, and charges in the order in which they became payable. The law should be clear on how payments will be applied to a taxpayer's account.

#### **7.1.7. Organization and Procedures**

As with most aspects of tax administration, there is no single perfect way of conducting business. There are, however, some general guidelines that will assist in designing an organization that is efficient, effective, and less costly than other alternatives.

### *Large Taxpayers*

Some administrations have placed responsibility for large taxpayers solely within the Large Taxpayer Office (LTO)<sup>17</sup>. Although the definition of who qualifies as large taxpayer varies between countries, there are general characteristics they have in common, including:

- Multiple operating entities;
- High volume of transactions in day-to-day business activities;
- Large number of employees;
- International business dealings;
- Unique industry characteristics (such as banking or oil and gas);
- Complicated issues (involving complex tax law and accounting principles);
- Complex financing and business structures; and
- Their own tax department to manage the tax affairs of the company.

Large taxpayers generally have a tax compliance function within their organization and designated person(s) responsible for the various tax returns, but large taxpayers sometimes fail to file returns or remit taxes.

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<sup>17</sup> LTOs are discussed in Chapter 4.

### Box 7.1. Compliance of large taxpayers in Bangladesh

In Bangladesh, a study of large corporate taxpayers<sup>18</sup> found that 84.4 percent of them file returns on time, but when reporting income their compliance drops to 53.9 percent. In paying taxes on reported income, their compliance was 75.3 percent. Interestingly, the study found that only about one-third (37 percent) of the large corporate taxpayers were simultaneously compliant with filing, reporting, and payment obligations. Conversely, 63 percent of large taxpayers were non-compliant at any given time in meeting their filing, income reporting, and/or payment obligations.

Large taxpayers as a small, select group are responsible for a high portion of tax revenue. Large taxpayers are critically important to a country's revenue, as this group usually comprises less than 5 percent of the total number of taxpayers but can account for 75 percent to 85 percent of the revenue. One late return or late payment can have a material impact on a government's revenue. This said, an LTO is responsible for a relatively small number of taxpayers, and these taxpayers are generally compliant for the purposes of timely filing and payment. Thus, the staff in the LTO that is responsible for tax arrears are also assigned the task of obtaining compliance for outstanding returns and current tax. Clearly, with the majority of the revenue for a country concentrated in relatively few taxpayers, the default by only a few on meeting their filing and payment obligations requires swift action. Strategies to do so are examined later in this chapter. From the tax administration's operational level, the most important element is being able to rapidly detect when a return is overdue or a payment is missing or short. Modern tax administrations rely heavily on computerization and the underlying procedures for this task.

What should be the appropriate target for large taxpayer compliance in timely filing and payment? Both the ideal situation and the reality should be a target of 100 percent compliance. The accounting systems for large taxpayers are almost always fully computerized and can produce the information required to complete a tax return very shortly after the close of the tax period. Thus, large taxpayers should be required to e-file their returns. Similarly, large taxpayers, in most cases, already have systems to pay their employees and suppliers directly into their bank accounts. This should also be the case for paying taxes. In this manner, a non-compliance report can be produced the day after the close of any tax period. Such a report will accurately reflect the compliance of this group of taxpayers and appropriate action can be taken immediately.

#### *Small and Medium Taxpayers*

Small and medium taxpayers are different from large taxpayers. First, they are numerous, but make up a small percentage of the government revenues. Their business organization may be both poor and inefficient and, unlike large taxpayers, they may not have highly qualified accountants on staff.

Small and medium-sized enterprises (SMEs) are perceived by most tax administrations as part of a hard to control segment of the tax base. This has resulted in special legislation applicable to only select

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<sup>18</sup> Akhand (n.d.), p. 11.

subsets of these taxpayers. In some countries, there is a presumptive tax<sup>19</sup> for select groups of taxpayers. Various countries, for example, have "simplified" methods of calculating the VAT liability of different categories of small VAT payers. The purpose of these simplified methods is to include a large number of taxpayers, who are usually self-employed or have a minimal number of employees, whose tax compliance has traditionally been hard to control, and who have low income levels and little impact in terms of revenue collection in the VAT base. These approaches have been adopted to facilitate small and medium taxpayer compliance by reducing their compliance costs. This is accomplished by simplifying formalities for record keeping, tax reporting, and tax payment. This is also logical, as the administration's resources are limited and higher skilled employees are allocated to control large taxpayers.

Administrative tasks toward the smallest taxpayers normally include verifying that they are correctly classified in the proper tax bracket (by revenue) or segment (i.e., market stall, taxi, barber, etc.) and ensuring that a periodic return and payment is made. In many countries the requirement for a return has either been removed or simplified to only a couple of information items. Periodic payment, of course, is required.

Almost all tax administrations in the world operate their small taxpayer programs on a voluntary basis. Taxpayers will register after self-classifying or self-categorizing their activity. A minimal amount of documentation is submitted and the tax administration usually does not verify the information. As previously mentioned, the only variable to classify the taxpayer is gross income, which is a parameter that is difficult for the tax administration to verify. Taxpayers will tend to register in the lowest tax brackets or categories. Thus, while they appear to be observing their tax obligations, they are benefiting from tax savings without running any risk, since no controls are exercised after registration. If controls are attempted, they are inefficient.

Presumptive and simplified regimes should not be skewed to collecting minimal information for the sake of expediency, if this will result in lack of compliance. As described below, presumptive and simplified regimes have flaws.

- One of the basic flaws is that these regimes initially prioritize attracting as many taxpayers as possible and the corresponding public campaign focuses on "selling" the benefits of joining the formal sector. Thus, many of the normal checks and verification are eliminated or administratively ignored. Crucial information about many taxpayers is questionable at best, with incomplete and invalid basic contact information, such as an address or telephone number. After a period of time, these errors become a problem and countries attempted to take corrective measures, but, by this time, the number of registrations is overwhelming and, often, tax staff assigned to the problem is poorly trained, with a lack of supervision and inefficient verification procedures.

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<sup>19</sup> In a presumptive tax regime, tax liability is computed using means other than the usual taxpayer accounting rules. This is usually done to simplify tax computations for small taxpayers or taxpayers in specific sectors. For example, a presumptive income tax could be computed as a fixed percent of estimated gross receipts or net worth.

- A problem with attempting to cleanse the information is that most tax administrations use business turnover for classification, which is very difficult to control, especially since the cleanup of the data is usually done from the confines of a tax office (i.e., without seeing the taxpayer's premises to try to verify, even visually, their statement of turnover).
- Another problem with cleanup of the tax filing and payment system, as it applies to presumptive taxpayers, is dealing with those who joined the system but understated their income so as to receive more preferential tax treatment. As previously noted, the determination of these taxpayers' actual income is very difficult and no prior action has been taken to verify whether they were properly classified. Even if this group was correctly classified, their revenue impact would be minimal, at best, and the tax administration would be left to deal with numerous complaints, bad relations, negative press, and possible political intervention since small taxpayers represent a large voting bloc.

These factors result in attempts to control the situation and encourage compliance by enacting a penalty regime that is ineffective given the minimal resources that the tax administration has available and the possible political problems with penalizing the smallest taxpayers. One option is for tax administrations to use matching computer databases to attempt to identify non-compliant taxpayers. Proxies of income, such as electricity consumption, water bills, cell phones, and third party sales, among others, are possible areas to examine. Undoubtedly, this exercise will identify non-compliance, but the tax administration must ensure that adequately trained and qualified persons are utilized. Otherwise, the same problems that developed with the initial registration will recur.

In summary, these special tax regimes that were designed to help small and medium-sized taxpayers to cope with transitioning from the underground economy to the formal sector were intended for a very large number of small taxpayers conducting low-income generating and hard-to-control business activities. Given their low incomes, they would have a negligible impact on total tax revenue. Rather than the regimes described above, simplicity of the tax system should prevail over revenue considerations. Thus, any formal obligations that this category of taxpayers must meet have to be considerably simplified. As a result, various tax obligations are usually replaced by a single, regular payment which discharges all tax obligations.

### *Addressing Small and Medium Taxpayer Compliance*

The problems created by a weak registration program should be addressed through a more robust screening of the initial registration information to verify to the extent possible.

- Addresses (where there is a formalized address system) are verified against the property tax database;
- Cell phone numbers are verified (although people often change numbers, and on prepaid phones this validation is generally non-productive);
- National Identity numbers (if in use in the country) are checked against the database;
- Passport number (although most small taxpayers do not have a passport); and



- Bank account information is required, which can be a problem with the smallest taxpayers, as banks may not allow them to open accounts.

Tax payment must be convenient, simple, and quick, including, for example:

- Payment accepted at any bank, without charge to the taxpayer; and
- A short payment form completed by the taxpayer which shows the TIN and current contact information (i.e., telephone(s), address). This basic information could be entered online by the bank and serve to update the contact information on file at the tax administration.

Mobile phones have also become an important additional electronic service delivery channel for this purpose that has grown rapidly over the past 5-10 years. The OECD previously reported that just over half of surveyed revenue bodies revealed the use of taxpayers' mobile phones for taxpayer service-related purposes. For the most part, the services offered were fairly limited and the volumes quite low.<sup>20</sup>

Invoices issued by small taxpayers operating under the presumptive tax regime cannot be used by VAT registered persons to obtain a credit for tax paid. This is designed to encourage small taxpayers to progress to the next level in the tax system and leave the special tax regime. This measure also reduces the problem of invoices being used to conduct VAT fraud. All persons importing goods through Customs must have a valid tax clearance certificate<sup>21</sup>. As discussed in Chapter 10, this action must be thoroughly planned and coordinated with Customs.

Finally, all persons supplying the government with goods or services must:

- Be registered as a taxpayer; and
- Submit a current tax clearance certificate.

### **7.1.8. Getting the Tax Return from the Taxpayer to the Tax Administration**

The first step in the filing process is getting the tax return from the taxpayer to the tax administration. Various methods are in use, ranging from using the traditional method of completing a hard copy and using either mail or hand delivery, to online completion with digital signatures and instant transmission, to tax software that interactively guides the taxpayer through the process and, where internet is available, transmits the completed return to the administration.

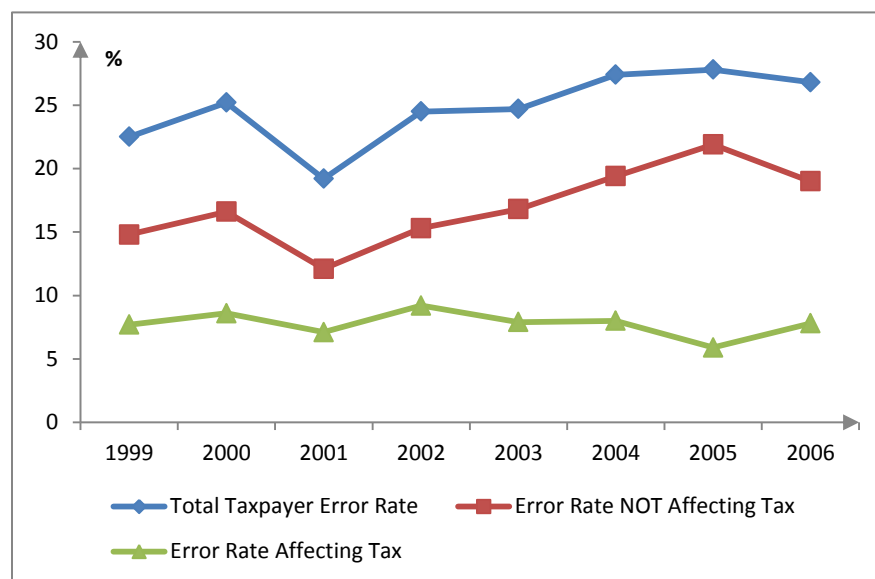
There are costs and problems associated with manual returns and archaic payment systems. Tax administrations spend large amounts of time and financial resources to print blank return forms and fold and stuff these forms in envelopes (in many instances, temporary staff are recruited). The process is delayed as the mail system in many countries can be slow. Paper returns must be entered manually. This is a slow process that can contain data entry errors and introduce inaccuracies into the taxpayer

<sup>20</sup> OECD (March 2010), p. 56.

<sup>21</sup> Tax clearance certificates are discussed in Chapter 10.

account. Data entry for individual tax returns can take several months and, in some cases, considerably longer, as the administration re-enters and reviews all the returns to try and resolve both taxpayer and data entry errors. Irrespective of the reviews, unspotted data entry errors can remain, which can be irritants to taxpayers. At the end of the process the paper returns must be physically filed, requiring staff and space. Manual filing systems are also prone to errors with returns being misfiled. Another weakness with hardcopy files is they can sometimes be made to "disappear" when crucially required as evidence in legal proceedings. Often countries require the tax files to be retained for anywhere from 6 to 10 years which requires secure space.

**Figure 7.4. Canada Revenue Agency error rate on personal income tax returns<sup>22</sup>**



### 7.1.9. Data Entry

It is important to note that the process of getting information from the return into the IT system should take advantage of as much automation as feasible (prefilling forms, barcodes, online fillable forms, etc.), and internal processes should be simplified and standardized across all taxes to the extent possible to decrease administrative costs, as well as to detect non-compliance as early as possible. This said, in cases where paper returns still exist, these returns have to be entered into the system manually.

Tax administrations may have a central data processing unit or may operate in a decentralized manner, with district offices responsible for the input of their taxpayers, and the LTO responsible for its own taxpayers. On receipt of the tax return, there are basically two divergent philosophies to posting a return to a taxpayer's account. Simply stated, the return is either:

- Subjected to a review process, where it will not be accepted as a completed tax return, unless it is correct; or

<sup>22</sup> Canada Revenue Agency (2007), p. 23.

- Posted to the taxpayer account "as-is" and the computer identifies errors for subsequent correction.

There are variations of either approach. For example, the taxpayer is provided with a receipt acknowledging a return has been filed, but the details of the return are held in suspense when an error is detected during data entry into the computer system and remain in suspense until the error is corrected. In this scenario, the system might be able to indicate there is a return filed, but the details may not be available. There are advantages and disadvantages to any system, but posting returns "as-is" becomes preferable when following the initial premise that non-compliance should be rapidly detected and addressed.

Returns should be captured electronically as soon as possible. Experience has shown that problems occur if data from returns are set aside for error correction rather than being captured immediately. The most common difficulty is the return is misplaced and cannot be located. This may necessitate contacting the taxpayer and, although there may be a record of it being filed, there is embarrassment that it has been lost. The second frequently occurring problem is the return is set aside for error correction, but other priorities and workload cause significant processing delays which then lead to the inevitable question about the efficiency of the administration. If a significant number of returns are held in suspense, efforts to conduct tax analysis and risk assessment could be adversely affected.

Tax returns containing errors must be corrected. Tax administrations have approached this in a variety of ways within their organizations. Approaches range from:

- Data entry operators setting aside the return when the computer system detects an error to attempt to resolve the error by contacting the taxpayer by telephone. Unresolved returns that cannot be resolved by the data entry section are forwarded, depending on the organization, to other functional areas, such as a dedicated return resolution unit, taxpayer services, collections, or audit;
- Returns rejected during data entry are automatically referred to an error resolution unit. This unit may be variously organized as part of taxpayer services, collections, audit, or revenue accounting. Depending on how the unit is organized, it may contain either clerical level staff, or it may require some higher level employees if its mandate is to resolve all issues, with the exception of the most complex situations; and
- Serious problems that cannot be resolved on the telephone, depending on the organization, are referred to audit, collections, or taxpayer services. The predominant preference of most tax administrations is to refer the return to the audit function.

Organizations have found that having data entry operators stop production to phone taxpayers is the least desirable process. Production suffers and, often, data entry personnel cannot answer any questions that may arise during the telephone contact.

## *Ergonomics of Data Entry*

Countries are moving toward e-filing as a means of reducing their costs and increasing the accuracy of the information as it eliminates data entry errors by the tax administration but for the foreseeable future there will remain the need for some data entry. As a result, modernization of the data entry work environment is an area that is also often overlooked, but significant gains in both output and quality can be obtained with minimal cost. The more efficient data entry processes have staff dedicated solely to this function, and the workplace is conducive to data entry as a production line process with ergonomically correct desks and chairs. The data entry work environment must be properly designed and adjusted to optimize the comfort, safety, and health of operators to ensure quality and productive output. For example:

- Computer entry tasks are best performed without arm rests. Arm rests can cause restricted forearm movement, pressure points, and stressful shoulder postures;
- Operators should be seated so that they can maintain a straight wrist—good neutral wrist posture—to avoid soreness often caused by working long periods with hands bent upward or downward and that can contribute to operators developing carpal tunnel;
- Proper positioning of the computer monitor and angling of the screen helps avoid screen glare and maintain relaxed neck and back postures. The monitor position should not require operators to tilt their head forward to view the text;
- Proper lighting is important. Windows, overhead lighting, and reflections from shiny surfaces can create glare and reflections causing eye strain. For example, a bright wall behind a dark computer screen can cause eye strain, because an operator's eyes must repeatedly adjust from the bright surroundings to the dark near-field of view of the computer screen;
- A document holder or copy stand that is properly positioned can make data entry less stressful, increase efficiency, improve posture, and allow operators to work more comfortably. A document holder that is placed close to the monitor reduces the head twisting to create less stressful eye movements;
- Data entry requires operators to constantly enter data into the computer using their keyboard and source document. For this arrangement, the keyboard and source document should be placed directly in front of the operator with the display off to the side. Documents should be the same height as the display;
- Excessive noise, uncomfortable temperatures, glare, and poor lighting affect operator comfort and productivity, as well as cause distractions. Too high or low light levels, or flickering overhead lights, cause fatigue; and
- Traffic in the work area, or operations near the data entry workstations, can sometimes cause distractions. The movement can distract the eye, decrease visual attention or concentration, and create fatigue.

### 7.1.10. E-Filing

Electronic filing (e-filing) is the transmission of tax return information directly from the taxpayer to the tax administration using the Internet.<sup>23</sup> E-filing options include completing returns online as either a self-prepared return, using a personal computer or tax preparation software.

As the IT systems operated by tax administrations are modernized, provisions are being made for e-filing. In addition, some administrations have introduced more sophisticated online tax filing systems that are interactive. These systems have mathematical checks and other prompts that replace the former manual checks that the tax administration performed during the vetting process. This modernization reduces the number of staff required for error correction and makes the system more efficient as the number of taxpayers to utilized electronic filing increases.

#### Box 7.2. E-filing in the United States

The processing of individual income tax returns by the Internal Revenue Service (IRS) of the United States during the 2009 filing season saw e-filing increase by 6.1 percent compared to the same period in 2008. The largest part of this increase was taxpayers e-filing from their home computers, which increased by 19.9 percent<sup>24</sup>. For the 2010 filing season, the IRS received nearly 61.3 million tax returns. Of those, 51.6 million were e-filed, and nearly 9.7 million were filed on paper (a decrease of almost 20 percent from the previous year). The IRS received nearly 60.5 million personal tax returns for the 2011 tax filing season – 53.9 million (89 percent) were e-filed and nearly 6.7 million (11 percent) were filed on paper.<sup>25</sup> The IRS received more than 63 million tax returns in the 2012 filing season: 57 million (90 percent) were e-filed and nearly 6.3 million (10 percent) were filed on paper.<sup>26</sup>

E-filing and e-payment (which is discussed below) have many benefits, including:

- Convenience – returns can accommodate the taxpayer’s schedule and be filed at any time – day or night;
- Saves time, as returns do not require taxpayers making a trip to get a physical return from an office or waiting for the return to arrive by mail;
- Increased taxpayer/client satisfaction;
- Certainty of delivery and quick confirmation of receipt, as tax administrations can provide an email confirmation that returns have been received;
- Fast refunds – allows taxpayers receiving refunds to get them sooner;
- Assures taxpayer privacy and security;
- Online help facilities and user guides;
- Use of online commercial tax preparation software;
- Eliminates data entry errors and improves data quality; and

<sup>23</sup> Dowe (2008), p. 6.

<sup>24</sup> Treasury Inspector General for Tax Administration (2009), p. 2.

<sup>25</sup> Treasury Inspector General for Tax Administration (2011), n.a.

<sup>26</sup> Treasury Inspector General for Tax Administration (2012), n.a.

- Reduces tax administration operational costs by eliminating the cost of handling paper returns, and staff requirements for data entry and file maintenance can be reduced.

E-services require the underpinnings of enabling policy and legislation, and technical infrastructure. The electronic representation of a document should be recognized as equivalent to paper in court proceedings, and the authentication of both parties and non-repudiation of electronic transactions, as well as message integrity and confidentiality, should be legally recognized.

#### **7.1.11. Assessment of Returns**

Once a taxpayer has registered, filed a return that is entered in the computer system, and paid tax, most tax administrations pursue the accurate and efficient assessing of returns. The assessment process, more typical of the income tax due to its inherent complexity, checks returns for errors and produces notices of assessments (acceptance of the return as filed or with changes in tax due) to let the taxpayer know whether they have properly filed their return and how much tax they may owe, along with conducting a limited verification of items on the return. With the increasing number of taxpayers, this is usually done with the help of computer systems. At the same time the cash area will ensure that the taxpayer's payment is recorded in the right account and for the right year and that a receipt is issued. Having an efficient system in this area is critical.

#### **7.1.12. Payments**

Many tax administrations have yet to accommodate electronic payments, and, therefore, taxpayers make payments at the tax office, government treasuries, and sometimes at the banks. The payments in tax offices and treasuries often result in long queues near payment due dates and the need for larger public service areas and additional cashiers to receive and process payments. When checks are returned by the banks, staff must be assigned to resolve returned checks with taxpayers.

With these challenges, many countries have adopted a system for taxpayers to make their payments at a bank. The payment is subsequently transferred to the government accounts in the Central Bank. One of the primary reasons for this change is to remove the tax administration from handling tax payments and reduce the opportunity for irregularities. Another major reason is the flow of tax revenues to the government is more reliable using the banking system, as most banks can electronically transfer or wire transfer the funds immediately after collection (such as on a daily basis) to the government tax revenue accounts. This system also makes the accounting for tax revenues more accurate and timely.

#### ***Benefits of the Bank Payment System***

The following are the benefits to the taxpayer of making payment at a bank:

- Convenient – the taxpayer can make payment at bank anytime during banking hours;
- Easy – the taxpayer can go to a nearby bank;
- Efficient – there is no waiting in lines at a tax office to file the return and make payments to a cashier, which is often a two-step process, where both steps require waiting in queues;

- Safe – the taxpayer can arrange with the bank for a transfer of funds from the taxpayer's bank account to make the tax deposit, reducing the need to travel with cash; and
- Accurate – the taxpayer has a bank receipt showing the amount and date of payment.

The following are the benefits to banks:

- More deposits and use of funds due to "float" time when funds are in the bank prior to payment and transfer to the tax administration;
- Taxpayers may deposit funds in their bank accounts prior to direct payment being made to tax administration;
- New customer potential, as taxpayers use banks more frequently for direct deposit of tax payments; and
- Potential for additional loans, credit lines, or similar transactions with customers making tax payments directly through the bank.

There are also numerous benefits to the tax administration:

- Better compliance with tax payment requirements;
- Generates more timely payment to the government;
- Accelerates the flow of tax funds into interest-paying accounts of the government;
- Better taxpayer relations, as payment of tax obligations is more convenient through banks;
- Better workload management, as number of "clerical" type transactions with taxpayers are reduced and more time is available for substantive tax compliance issues;
- Greater efficiency, effectiveness, and accuracy of tax payments, contributing to improved tax accounting;
- Automated (computerized) system for transfer of tax payments from taxpayers to the government treasury reduces errors in transposition of figures and other data entry problems;
- Provides the foundation for centralized filing in regional computerized service centers;
- Computerized systems are able to generate more accurate and more timely management information reports regarding tax revenue collection and payment;
- Reduces the need for maintaining a cashier function, or reduces the staffing level for handling cash and check transactions;
- Increases the ability of the tax administration to concentrate more on the accuracy and timeliness of return filing, thereby generating improvements in the self-assessment system; and
- More stable tax revenue as taxpayers increasingly file more accurate returns and amending returns and subsequent tax adjustments are reduced.

### *Bank Payment System Risks*

Four of the basic categories of risks in the payments process are liquidity risk, operational risks, security risks, and legal risk.

- Liquidity risk arises from the possibility that the sending party (the taxpayer or the taxpayer's financial institution) may fail to meet its payment obligation on the due date because of an unforeseen shortfall in available funds. Liquidity risk involves a loss to the receiving party (government), which must now implement the arrears collection process against the taxpayer. Of course, this could be a problem even when taxpayers make payments directly to the tax administration's cash office. However, since a single bank handles multiple taxpayers, the problem is more serious if the financial institution fails to meet the payment obligation. However, assuming the Central Bank (or another entity in charge of bank supervision) is conducting appropriate and effective monitoring of the financial system, it should be aware of the insolvency of a financial institution long before the problem and be able to take appropriate action;
- Operational risks arise with the possibility of human error, equipment malfunctions, natural disasters, or system design flaws that can result in payment errors or incompleteness of the transaction;
- Security risks, such as the risk of fraud, can leave a party subject to financial loss. Security risks include the risk to privacy if the system is hacked and the perpetrator gains access to confidential payment information that can be used to exploit the financial information; and
- Finally, there is also a legal risk. Given that there is a third party involved (the banks), it may not always be clear who the liable party is when something goes wrong.

To mitigate some of the tax administration's risk, various safeguards should be implemented, such as:

- Strong internal and data processing controls on all programs;
- Written agreements establishing procedures and risks; and
- Implementation and periodic review of internal controls that address access control, confidentiality of data, integrity of data, and other information security issues, as appropriate.

As an example, many of Canada's municipal governments have introduced a Tax Installment Pre-Payment Plan (TIPP). This is a monthly tax installment payment plan that allows property and business owners to make consecutive monthly payments for taxes, rather than an annual payment or semi-annual payment. TIPP is an automated program that taxpayers establish with their local government, and it automatically withdraws payments from their designated bank account. The system is set for payments to be made on a specified day each month by automatic withdrawal from the designated bank account, with the number of installment periods chosen by either the municipality or the taxpayer. Installment plans can be flexible with, for example, property tax installment periods between 7 and 12 months, and business tax periods between 6 and 10 months. The monthly payment is calculated by dividing the previous year's tax levy by the number of installments chosen for the calendar year, plus any applicable charges that the municipality may add. Frequently, the municipality does not add any charges to encourage taxpayers to use this system, as there is a net benefit to the municipality when taxes are automatically deposited. At the time of the annual tax billing, taxpayers will be notified of the total amount of installments paid to date and the calculation of the new installment amounts for the remaining payments in that year.



## **Bank Compensation**

Prior to implementing a bank payment system, the tax administration should first consider the costs associated with implementing online procedures and services. Many of these costs will be associated with the financial institutions and the online services that they can provide. The financial institution will require financial compensation. A tax administration should determine if the change is financially feasible and whether the taxpayers will accept the new system.

Banks are normally compensated in one of three ways:

- Negotiation of a certain number of days that the bank is allowed to retain the tax payments (float), with no fees payable;
- A flat rate per tax payment, which is deducted daily, and the net amount is deposited to the government accounts no later than the close of each business day; or
- A percentage of the tax payment is negotiated, which is deducted by the bank from the total amount deposited to the government accounts, no later than the close of each business day.

The compensation from country to country varies widely. It depends on the anticipated volume of transactions, with a small country paying what can be a high fee relative to a country with a large number of transactions. For example, the negotiated fee charged by banks typically ranges from 0.75 percent to 2.5 percent of the amount of the tax payment. "Float" time alone (i.e., that banks can use the money before transmitting payments to the government) is often sufficient and acceptable compensation to banks.

### **7.1.13. E-Payments**

An e-payment is the transfer of money from a taxpayer's bank account to the tax administration's bank account using the Internet. E-payments can be made online, at any time (during and after banking hours), and from any location. In comparison to a bank payment system, e-payments offer the following additional benefits:

- Convenience – e-payments can be made at any time and can also be scheduled for a later date;
- Reduced payment cost to taxpayers – replaces the use of checks, and many banks provide free online payment services;
- Increased taxpayer/client satisfaction;
- Speedy revenue collections;
- Reduced check handling costs for tax administrations – not having to deal with checks backed by non-sufficient funds; and
- Timely information on payments to aid in reconciliation and revenue reporting.

### **7.1.14. Implementing E-Services**

Successful implementation of e-filing and e-payment systems requires: (1) reliable and accessible internet service; (2) cooperative financial institutions that have the IT infrastructure to support e-

payment; (3) IT literate taxpayers; and (4) adequate financing to set up the appropriate infrastructure in the tax administration. An e-filing and e-payment system should form part of a larger comprehensive IT strategy. This topic is discussed in Chapter 12.

### *Issues for E-Services*

One of the biggest issues for most tax administrations is the difficulty they have in retaining sufficient IT expertise. Other concerns include:

- E-commerce – in particular, the use of digital signatures and data encryption may require legislative amendments to support e-filing;<sup>27</sup>
- Information security issues surrounding the transfer of information, integrity, and confidentiality;
- Possible fraud risks through false taxpayer identification, refunds, *etc.*;
- The ability to address taxpayers' concerns (given that interactions between the taxpayer and the tax administration are limited); and
- Staff concerns about job security (given that e-services may replace traditional positions).

Many countries have gradually introduced e-filing and e-payment, first making it voluntary for a select few taxpayers, such as those in the LTO, to allow for live testing of systems and procedures. After testing is complete, e-filing becomes mandatory for certain taxpayers, and voluntary e-filing and e-payment is extended to the general taxpayer base.

Many countries continue to limit e-filing to only certain taxes or where returns are below thresholds. The tax administration always has the legal right to question any tax return, request supporting documents, or audit any tax period (within statutory time limits). Where there are strong e-commerce laws and e-file provisions are supported by the law, although there may be some administrative reason for retaining an insistence for paper returns, there is presumably no legal barrier. Other administrations have taken a relaxed position, with certain caveats. For example, professional accountants and tax agents, who have been certified by the tax administration, may file almost all returns online with few exceptions. One of those exceptions is the final income tax return for a deceased person, where many jurisdictions require court documents attesting to the legal capacity of the executor of the estate.

During the implementation of e-filing, some of the commonly encountered taxpayer questions the tax administration must anticipate in advance are:

- How do e-filing and e-payment work?
- What are the benefits of e-filing and e-payment?

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<sup>27</sup> In the United States, the Internal Revenue Service (IRS) uses a "self-select personal identification number (PIN)" as one method of signing income tax returns electronically by taxpayers. The self-select PIN method requires taxpayers to provide their prior year income amount or prior year PIN for use by the IRS to authenticate the taxpayers. Taxpayers may also authorize their professional tax practitioner to enter PINs on their behalf, in which case the taxpayers must review and sign a completed signature authorization form after reviewing the return.

- Am I eligible to e-file?
- How can I e-file and e-pay?
- Is it safe and secure to e-file and e-pay?
- Can a third party e-file for me?
- What if I owe money when I e-file - how do I pay?
- Can I set-up a special account to e-pay?
- Is there a fee to e-file or e-pay?
- How do I know if my e-filed return has been received?
- Do I need to submit any paperwork or supporting documentation if I e-file?
- How do I sign my electronic return?
- How do I amend my e-filed return?

In addition, banks may not be equipped to offer these services; the service fees proposed by financial institutions may be too high; there may be no inter-bank clearing service in the country; and the public key infrastructure that would provide optimal facilities may not have been developed.

### *Lessons Learned Implementing E-Service*

Important lessons learned from implementing e-services include:

- A good public awareness program is absolutely necessary to achieve high e-filing take-up rates. This awareness program should be well researched, as much depends on what is workable in the each individual country. For example, direct telephone calls to taxpayers and practitioners worked very well for the authorities in Denmark. Some countries realized increased participation in the program as a result of explanatory information provided to taxpayers, tax forums, and education seminars;
- Based on the type of questions received during the initial pilot stage, countries found that it was important to address the needs of taxpayers in a well-developed plan before the general implementation phase and once into the implementation phase it was important to provide adequate and timely information to stimulate take up by taxpayers; and
- Relationship building with other interest groups during the implementation process is critical. The development of an e-payment system must be done in conjunction with local financial institutions. Countries that have partnered with financial institutions, tax practitioners, and other organizations have seen greater acceptance and use of the system and higher satisfaction levels. An especially important aspect is the face-to-face interviews with tax practitioners in the early stages of the development of the system. It was these tax practitioners that, once convinced of the benefits, assisted the tax administrations to promote e-filing and e-payment.

#### **7.1.15. Refunds**

Refunds arise naturally in many tax systems. In both income tax and PAYE, there will be taxpayers that have overpaid their tax and be eligible for refunds. In some countries, the PAYE tables that employers use to calculate the amount to be withheld from an employee may deliberately cause slightly more tax

being withheld than is required, with the result that an employee must file an income tax refund return to recover this overpayment. In other countries, the design of the system may have advance payments of income tax applied to various types of transactions, such as on imports of goods through Customs, which requires reconciliation on the annual income tax return and can result in a refund. The level of VAT refunds depends on the value added of exported goods, the extent of the zero-rating provisions, and the use of multiple rates.

A frequently asked question is whether the level of refunds being paid as a percentage of gross revenue for any particular country is "normal." The results of an OECD survey of tax administrations are shown below. Refunds vary widely, due primarily to the tax system design features of each country.

**Figure 7.5. Percent of gross tax collections refunded to taxpayers in 2007<sup>28</sup>**

Country	Personal income tax	Corporate income / profits tax	Value added tax	All taxes
Australia	14.5	10.8	46.1	20.1
Canada	13.2	20.4	n/a	21.6
Hungary	6.4	13.5	42.8	17.4
Ireland	19.1	12.8	24.6	13.9
Japan	4.3	1.6	6.5	12.6
N. Zealand	4.3	3.0	46.1	16.7
Korea	3.6	10.3	41.6	18.9
Slovenia	11.0	9.1	38.1	-
Spain (2006)	14.7	11.2	31.0	18.0
Sweden (2006)	5.0	-	41.0	-
UK	-	-	40.8	13.3
USA	18.2	6.8	n/a	11.0

### *Paying Refunds*

Many countries are concerned with paying refunds promptly, since payment of a refund within a certain period can be a legislative requirement. Additionally, if a refund is not paid within the allotted time, the tax administration must pay interest to the taxpayer. It is important that refunds are paid promptly since this money is legally due to the taxpayer. When governments fail to honor a taxpayer's entitlement to a refund it can adversely affect tax compliance as taxpayers will find other means to recover their entitlement such as netting refunds against liability and reporting only the net amount, or less.

### *Refund Fraud*

A primary reason for many administrations' delays in paying refunds is the potential of fraud, especially as related to VAT. Frauds exploiting the VAT system are large. In Europe, a 2007 study by the European

<sup>28</sup> OECD (January 2009), p. 100.

Commission estimated that VAT fraud costs the member states an estimated Euro 60 billion annually<sup>29</sup> in just one type of fraud scheme.

The focus of tax administrations on the processing of all claims with speed and the time constraints placed on them generally leaves little time for any substantive investigation and no time or available resources to conduct an audit at the taxpayer's premises. Processing refunds becomes a desk-based review that is largely a mechanical operation ensuring all documentation is present. These operational "gaps" that leave the refund system susceptible to refund fraud are, as many countries are finding, often exploited, with sometimes huge amounts being paid to the perpetrators of these frauds. Worse, because of weaknesses in the registration system, the perpetrators of the fraud sometimes cannot be subsequently located.

Tax refund fraud is on the rise in many countries, as it is relatively easy to commit due to the lack of adequate detection tools used by most countries and, in many cases, the inability of tax authorities to cooperate with police because of the secrecy provisions in the tax laws that prevent disclosure to other agencies. As shown in the table below, the number of refund frauds that were identified in the United States increased in 3 years from about 457 thousand to over 2 million.

**Figure 7.6. Fraudulent returns and refunds in the United States in 2009-2011<sup>30</sup>**

Processing Year	Number of Fraudulent Refund Returns Identified	Number of Fraudulent Refund Returns Stopped	Amount of Fraudulent Refund Returns Identified	Amount of Fraudulent Refund Returns Stopped
2009	457,369	369,257	\$2,988,945,590	\$2,517,094,116
2010	971,511	881,303	\$7,300,996,194	\$6,931,931,314
2011	2,176,657	1,756,242	\$16,186,395,218	\$14,353,795,007

European tax administrations not only have a problem with income tax fraud, but also a considerably larger problem with VAT "carousel fraud." In this type of fraud, goods are imported VAT-free from another country in the EU, but are not sold for consumption in the home market. The goods are sold through a series of companies, each liable to VAT, before being exported, possibly even back to the original seller. In carousel fraud, the first link in the chain of businesses goes missing without accounting for the VAT. The final link in the chain reclaims the VAT it has paid from the government before disappearing. This type of fraud generates high returns over a short period of time; it is difficult to detect, and it is difficult to prove. VAT refund fraud is addressed in further detail in Appendix 7.A.

### ***Risk-Based Refund Management***

Tax administrations are attempting to tighten up the refund system, but also trying to maintain an acceptable turnaround time in processing refunds. Part of the solution is implementing risk management. This entails categorizing refund applications by risk indicators and quickly processing

<sup>29</sup> Financial Action Task Force (2007), p. 3.

<sup>30</sup> Electronic Tax Administration Advisory Committee (2012), p. 24.

those that are low risk. By processing the low risk refunds with minimal scrutiny, the tax administration can devote extra resources and time to those that are high risk.

In the absence of a formalized program to determine risk indicators, and as an interim step until a risk management program is instituted, a rudimentary three-level risk categorization could be used. For example, in the case of VAT refunds, including those tax returns where there is an abnormally large credit that is to be absorbed by future returns, the following risk categories can be used:

- Category "A" claimants could be those where there is minimal risk. Claimants in this category could be those who are traded on a stock exchange, have audited financial statements by a major firm, are compliant with all taxes, and have had a tax audit within the last 2 years. These claimants/taxpayers should be treated as valued "customers," should not be subjected to frustrating delays, and should be issued prompt refunds.
- Category "B" claimants could be those with a medium risk. These claimants would have audited financial statements, but not necessarily by a major firm. They have been registered for more than 2 years, have a history of reasonable compliance (although some returns may be late), have had a tax audit where the auditor visited the claimant's premises, and the suppliers to the claimant on which the refund is based are known and are also reasonably compliant. These claimants/taxpayers are also valued "customers," should not be subjected to frustrating delays, and should be issued prompt refunds. Of course, post-refund audits can be conducted, if subsequent information should trigger such action.
- Category "C" claimants are high risk. These claimants would not necessarily have audited financial statements, would have a history of non-compliance or "nil" returns, and may have recently registered. They have not had a tax audit, or there may have been an audit, but the auditor did not actually visit the premises (desk audit). In addition, the suppliers to the claimant may either be non-compliant or the tax claimed based on the documentation is in excess of the tax returns that have been filed by these suppliers. Claims of these taxpayers should be subject to pre-refund audit.

VAT offers distinctive opportunities for evasion and fraud, especially through abuse of the credit and refund mechanism. In many tax systems, refunds are processed through desk audits where copies of supporting documents may be examined. These supporting documents can be easily "created" using a computer to generate false invoices or even by simply altering a photocopy. It is important that the tax administration take a more holistic approach to refunds, by examining the credibility of the supplier, as well as the refund claimant.

It is especially important where registered persons have not been previously audited that the tax auditor be aware of potential signs of fraud.<sup>31</sup> Where a visit to the claimant's premises is warranted, an attempt should be made to assess the likely future trading pattern of the business. This information would be noted in the audit case record as an aid to the verification of future refunds.

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<sup>31</sup> The audit process and techniques are discussed in Chapter 8.

There may be cases where it is difficult to contact the VAT refund claimant. This may be an indication that the business is not genuine, particularly if the business has not been previously visited. Where contact with the claimant cannot be easily made, it is important to check the existence of a genuine business at the address provided.

#### **7.1.16. Stop-Filer Detection**

The early detection of stop-filers and corresponding action are essential. Stop-filers are defined as taxpayers who have registered with the tax administration and been issued a TIN at some time in the past, but have stopped filing tax returns.

How does a taxpayer become a "stop-filer"?

- If a registered taxpayer does not submit a monthly VAT or PAYE return (or any other return by the due date), then the taxpayer will become a stop-filer for that tax period. Each registered taxpayer must file a VAT or PAYE tax return for each tax period (in most countries VAT and PAYE are filed monthly, with possibly exceptions for small businesses and seasonality)
- If a registered taxpayer decides to submit a "consolidated return" (a return that would combine one or more tax periods), then the taxpayer will become a stop-filer for those periods (e.g., a taxpayer does not submit a return for June, July, and August, but in September files a consolidated return for the three months – in this case, the taxpayer would be a stop-filer for June, July, and August). Taxpayers need to be informed that consolidated returns will not be accepted – a separate return is required for each month.
- If a registered taxpayer does not file a monthly return because there are no taxable transactions, the taxpayer will become a stop-filer. Taxpayers must be informed that they must submit a monthly return even if there are no taxable transactions.
- If a registered taxpayer fails to notify the tax administration that the business is no longer in operation, then the taxpayer becomes a stop-filer.

The following are reasons to promptly deal with stop-filers:

- If a taxpayer does not file, the taxpayer is not remitting tax, which has an impact on revenue collections.
- VAT/PAYE stop-filers should receive priority attention, because the taxpayer has collected the tax from customers. In the case of PAYE, this is tax that has been deducted from employees. The taxpayer has no legal right to retain the amount collected – these are payments in trust.
- A level playing field should be created for all taxpayers, as every taxpayer should be subject to the same rules -- if taxpayers believe others are not filing, they themselves may stop complying.
- Prompt collection of arrears is considered essential, as the chance of success is higher if the arrears are collected before the amount reaches an uncollectible amount. It is essential that the amount of these arrears is known as quickly as possible by ensuring that taxpayers submit their tax returns.

The quick processing of returns, preferably in an automated system, is essential for the quick detection of stop-filers. As an example, e-filed returns should be posted to taxpayer accounts within 2 working days of receipt,<sup>32</sup> and the bulk of the data from all paper-filed returns should be entered within 5 - 10 working days<sup>33</sup> from the filing due date. At this point the computer system should be able to indicate that a return has been received, and, conversely, should be able to produce an accurate report of taxpayers that filed in previous years, but not in this year – stop-filers.

The stop-filer report should also rank the taxpayers based on the estimated revenue at risk using historical data and any other risk factors that may be applied by the computer system, to allow the tax administration to address stop-filers with highest risk to revenue first. The supervisor responsible for stop-filers would then assign the non-compliant taxpayers to the tax officers responsible for obtaining the delinquent returns. The tax officers would use the risk ranking to determine their priority in contacting the taxpayer. In a fully automated system, the stop-filers would be assigned to individual tax officers by the supervisor on the system (or automatically by the system). An administration that does not have such capability should provide tax officers with a manually prepared assignment list.

In the United States, the IRS uses three phases for collecting unpaid tax liabilities in an "assembly line" approach for collection cases. The cases flow through each of the below phases until they are determined to be uncollectible, collected, or otherwise resolved:

- Notice stream: The IRS sends a series of balance due notices to the taxpayer to prompt a reply or payment by the taxpayer. Statutory requirements provide that the IRS send one notice of deficiency for each assessment to the taxpayer. Accordingly, the notice stream begins with the issuance of the statutory notice, which is generated by the Master File, followed by reminder notices, which are generated by the Integrated Data Retrieval System.
- Telephone contact: IRS employees attempt telephone contact with the taxpayer to prompt a payment or take enforcement action that may include levying financial assets or filing a lien against property.
- In-person contact: Revenue officers contact the taxpayer to prompt a payment or take enforcement action, including levies, liens, and seizures of property.

Tax administrations have been trialing alternatives to making the first contact with stop-filers by telephone. Many tax administrations have stopped routine mass mailings<sup>34</sup> using the post office due to the high cost and, in some countries, the inefficiencies of the mail system. Stop-filers would be contacted by telephone; however, this is labor-intensive, and call-backs are often necessary in order to

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<sup>32</sup> This assumes there is an online system with interactive prompts to detect basic math errors and prompt the taxpayer to correct the issue.

<sup>33</sup> A lot depends on the data entry system employed and the volume of tax returns. In smaller countries with centralized processing, the time frame is realistic. In some situations, the LTO is responsible for their own data entry and are dealing with very small numbers of taxpayers where, for instance, all VAT returns can be posted within only a couple of days. LTO operations should have a goal of all tax returns being e-filed with returns posted the following day.

<sup>34</sup> In the United States for example, approximately 20 percent of all taxpayers change addresses during the year thus mailing notices has a high rate of non-delivery.



speak directly with the non-compliant taxpayer. Due to confidentiality issues, messages cannot be left with other persons. In the context of an LTO, telephone calls are the preferred method since taxpayers assigned to the LTO should be close to 100 percent compliant, and the number of calls to be placed is very small.

In a study by the U.S. Treasury Inspector General for Tax Administration<sup>35</sup>, it was discovered that the first notice that was sent to the taxpayer resulted in 2.79 times more closures than all other notices combined. This first notice also collected 1.84 times more dollars than all other notices combined and generated 2.02 times more taxpayer responses than all other notices combined.

### *Project Approach to Stop-Filers*

A stop-filer project is a separate component within a tax administration designed to increase the compliance of large taxpayers. By focusing on only large taxpayers, it will prevent the staff assigned from being overwhelmed by unmanageably high numbers of low tax liability taxpayers. This project is concerned only with obtaining the tax returns of stop-filers.

The project is initially focused on taxes which are trust funds (VAT and PAYE) and are collected on behalf of the government by large taxpayers. After addressing these taxes and being satisfied that systems and procedures are sound, the scope of the special project should be enlarged to include the other taxes.

Implementing the stop-filer project is a major undertaking. It will be one of the most visible components of the tax administration, but, unlike other functions in a tax administration, such as enforced collection or audit, it should not be socially and politically sensitive, since it is only concerned with obtaining a tax return and associated payment.

### *Stop-Filer Process – An Overview*

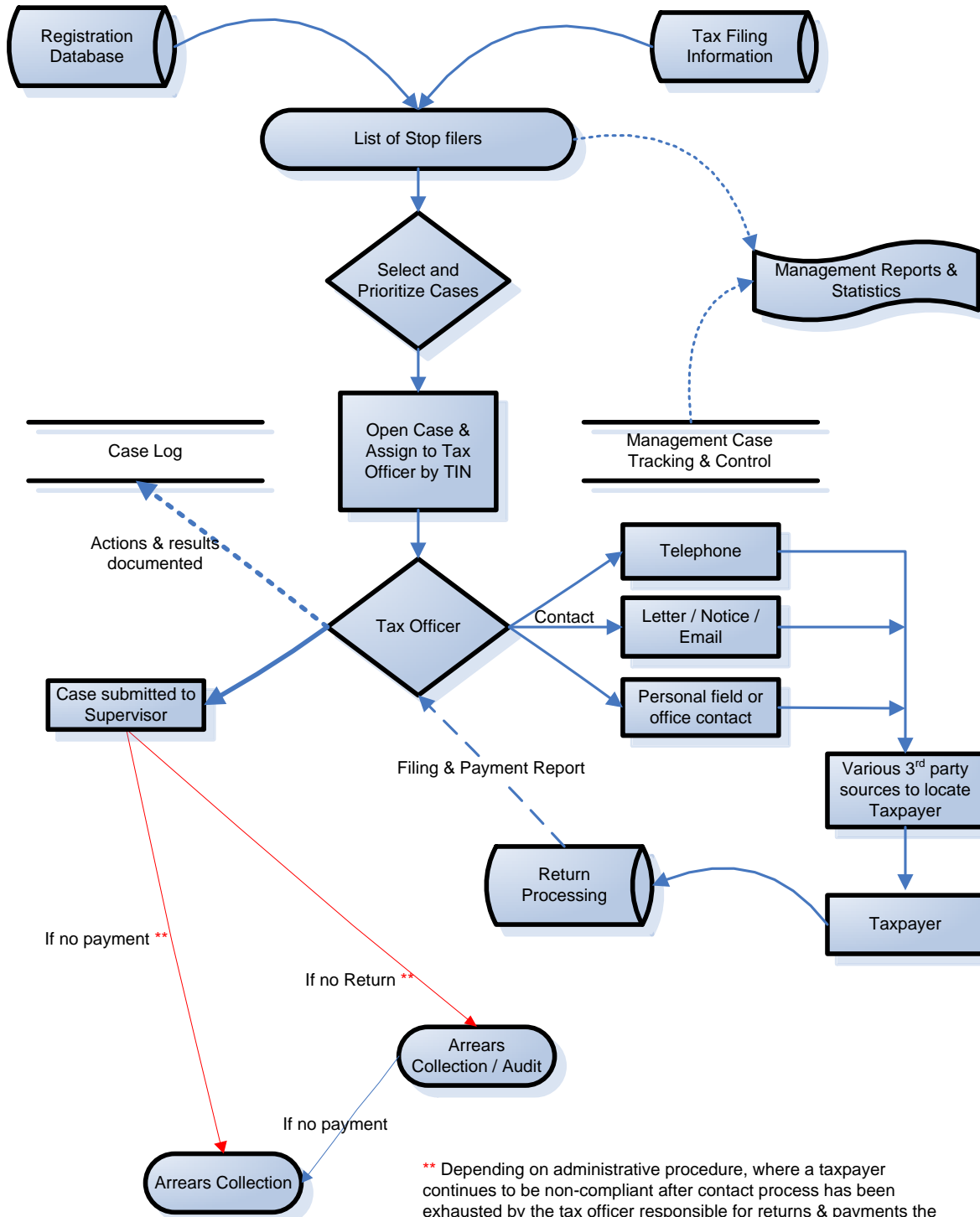
This is a general outline of the steps taken when a taxpayer fails to file their return. The description of how the team would work on stop-filer cases is only indicative and would vary significantly depending on the capability of the computerized tax system, the front-end data processing timeframes, country infrastructure (such as telecommunications), and the organizational structure of the tax administration. The flow of work is illustrated on the below flow chart.<sup>36</sup>

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<sup>35</sup> Treasury Inspector General for Tax Administration (2011), p. 2.

<sup>36</sup> Source: Previous work of author.

Figure 7.7. Stop filer process flow



\*\* Depending on administrative procedure, where a taxpayer continues to be non-compliant after contact process has been exhausted by the tax officer responsible for returns & payments the case may be referred either directly by the tax officer or a recommendation may be made by the tax officer to the supervisor to transfer the case to either Arrears Collection or Audit for action.

The procedures described below are guidelines and are not intended to be a list of the sequential steps that an officer must follow. The team supervisor will need to determine when it is effective and appropriate to use the different steps and actions. The following is a summary of the possible procedures and steps:

### **Step 1. Generate list of Stop-Filers**

The team supervisor should use the computer system to print a list of stop-filers. In some systems, this is already a pre-defined report that can be run at any time. In other countries, the computer system may have limitations and it may be necessary to work with the IT section to run a custom report. The stop-filer list should be produced approximately 7 to 10 days after the VAT / PAYE return due date.

At the outset of this project, the number of stop-filers can be large. Using the previously cited case of large taxpayers in Bangladesh, less than 40 percent were completely compliant. The list should be ranked or prioritized. The longer the time period that has elapsed since a tax return was required to be filed, the lower the likelihood that stop-filers case actions will be quickly resolved. For example, a large taxpayer who ceased to file all VAT and PAYE returns for the previous six months may be in financial difficulty and could already even be in bankruptcy. Alternatively, the staff member responsible for the returns may have left the business, and the new replacement may not be keeping the required records or even be aware of the requirement to file returns.

### **Step 2. Team supervisor considers sending an automatic "Stop-Filer Reminder Letter"**

The supervisor may elect that a reminder letter be sent to each taxpayer who has failed to file a return. The taxpayer may have simply forgotten to file the return, and, therefore, the letter may serve as a timely reminder to file.

### **Step 3. Supervisor creates and assigns stop-filer cases to team members**

The supervisor will open a case and assign it to a tax officer. In some computerized systems, cases can be assigned on the computer system to employees and also tracked on the system by the supervisor. The system may also have a "case log" (diary) where the actions taken are recorded by the tax officer in chronological order. The case log where the actions of the tax administration are recorded and the taxpayer responses are also entered can be an important document should the case should go to court. Other countries may not have as sophisticated a computer system. In this situation, it becomes necessary to use the manual procedures that were in use before computerization. Handwritten case logs that document the action taken on a taxpayer file must be kept. Similarly, manual control must be maintained by the supervisor.

### **Step 4. Complete the taxpayer profile**

In manual systems, taxpayer files are often unreliable, out-of-date, and incomplete. For this reason, a standardized taxpayer profile form should be created. It should be completed and, when the taxpayer is first contacted, the information should be reviewed with the taxpayer to ensure it is accurate. This is an

opportune time to capture detailed contact information such as FAX numbers, e-mail addresses, and cell phone numbers, as these can all be used if it is difficult to reach the taxpayer by telephone, or should the administration begin a project to routinely contact non-compliant taxpayers in this manner.

The review of information is also important in the event of legal proceedings or fraud cases. Where the taxpayer is a partnership, the members of the partnership should be reviewed with the taxpayer to ensure there have been no changes. If the taxpayer is incorporated, a copy of the corporation's registration should be available in the file. If it cannot be located, a copy should be requested from the taxpayer.

#### **Step 5. Examine previous history of non-filing**

The team member should check to see if the taxpayer has any previous history of non-filing. At this point, there are two possible outcomes:

- It is determined that the taxpayer's tax return filings are up-to-date. The team member will make the corresponding entries in the case log and return it to the supervisor; or
- It is determined that there is a problem with the taxpayer's information on file, or there is a problem with the tax returns.
  - Where returns are in the computer system or the appropriate ledger, but a hard copy is not on the tax file, the taxpayer should be asked to provide a copy of the return;
  - Where a return is on the file but not on the computer system or the appropriate ledger, this will be referred to the supervisor to request the correction of the situation through the data entry section; and
  - Where there is no record of a return, the taxpayer will be requested to file it (with payment).

#### **Step 6. Contact the taxpayer by telephone**

The taxpayer is contacted by telephone to find out why the return(s) has not been filed.

- If the taxpayer indicates the return has been filed, then ask the taxpayer to submit proof that the return has been filed;
- If the return has not been filed, the taxpayer should be informed of the penalties and interest that will accrue until the return is received;
- If the taxpayer indicates there are no taxable transactions in the case of VAT, or no employees to withhold tax from, then explain that the taxpayer must submit a "nil" return immediately;
- If the taxpayer needs assistance, then an appointment should be made for the taxpayer to visit the taxpayer services section. In some countries, this may be the responsibility of another section, such as either the collections or audit function to explain the proper filing of returns and assist the taxpayer.

This first call is very important, as it provides the opportunity to review and update, if necessary, contact information and to provide taxpayers with a positive impression of the tax administration. Every effort should be made during this telephone call to secure agreement from the taxpayer that the missing return(s) are submitted to the tax administration within one week.

When the call to the taxpayer is completed:

- The details of the call are to be entered by the team member in the taxpayer case log, and, if contact details have changed, this should also be changed on the computer system.
- The team member will enter the taxpayer return submission date in the "bring-forward"<sup>37</sup> diary in the computer system to check to determine if the taxpayer has submitted the return. If the computer system does not have a "bring-forward" feature, then a manual diary system will be necessary.
- Where the taxpayer has indicated they require a tax return form and it is not available for download from the tax website, a form should be either e-mailed or faxed to the taxpayer. This action would also be recorded in the case log.<sup>38</sup>

#### **Step 7. Reminder to the taxpayer**

Although not always a step in the stop-filer process, the taxpayer is contacted on the "bring-forward" date as a "gentle" reminder that a return submission date was agreed to. This would be done where the tax officer assigned to the case performs a quick search of the computer system and it does not show any change to the taxpayer account (a return or payment). This action may be by e-mail, telephone, or text message. This action is also recorded in the taxpayer log.

#### **Step 8. Visit the taxpayer to secure the return**

Within a few days following the agreed return submission date, the team member will check records to ensure the return(s) have been submitted. When this is done depends on the tax administration's systems and procedures. Where the procedure is to acknowledge on the system that a return has been received on the day it is submitted, or if returns can be accepted electronically and posted to the taxpayer account as they are received, then the team member should check the system the day after the taxpayer committed to filing the return. In technologically advanced systems, this check is automated and the "bring-forward" will either be cancelled or it will be noted that the return has been received, and a notation in the case log will be automatically entered.

If the initial telephone contact has not worked, the officer may consider two alternatives:

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<sup>37</sup> A diary or calendar where an action by the tax officer is to be taken at a future (forward) date is entered. In most situations, this is an electronic diary that will remind the tax officer at the beginning of the work day of actions that had previously been entered that are now due when organizing the daily workload.

<sup>38</sup> An example collection case log is provided in Chapter 10. Stop-filer case logs will largely mirror the collection case log section dedicated to recording actions taken to contact the taxpayer.

- A repeat telephone call, but with a "stronger tone" requesting compliance. Where a telephone call is made, it will be confirmed with the taxpayer by email. The email will be printed and retained in the taxpayer file, and an electronic copy will also be retained. In this situation, the reasons for non-compliance with the agreed submission date will be noted in the contact log. A new submission date will be agreed with the taxpayer, and, where possible, this new agreement should not extend beyond 2 weeks. An earlier date is preferable, if the taxpayer will agree.
- Visiting the taxpayer or making an appointment for the taxpayer to attend a meeting at the tax office with the objective of helping the taxpayer prepare the return. The following are some guidelines and tips:
  - There may not be enough resources to visit each taxpayer; therefore, with assistance from the supervisor, it will be necessary to prioritize the taxpayers that should be visited
  - The largest taxpayers that have not filed should be visited, as this could have an important revenue implication. It is important if a visit is to be conducted that there is coordination with other areas in the tax administration to determine if, for example, there is an audit visit scheduled, so that the taxpayer does not receive multiple visits.

#### 7.1.17. Public Perceptions and Compliance

The public's perception of the tax system depends on a number of factors, including the extent to which the public views the government as legitimate and whether the public perceives that funds are being misappropriated through corruption, wasted, or misdirected to projects that do not address public priorities or needs. If people generally support the government and have a positive view of the government's spending of "their" tax contribution, then it stands to reason that they are more likely to comply with the tax laws. The more the public perceives that funds are being misappropriated through corruption, the higher the rate of non-compliance.<sup>39</sup> It is critical, as part of the equation on gaining tax compliance, that a government is seen to be wisely spending. Even where funds are being spent wisely, the government needs to communicate that people are receiving the benefits of paying tax. The government should use opportunities, such as the opening of a new school or medical clinic, or the completion of roadwork, to demonstrate to the public that tax revenue is supporting critical investments and public services.

Public perceptions will change, if the public has a better understanding of why taxes are imposed. This understanding will also improve the concept of the legitimacy of the tax regime. Possibly tax administrations and government should consider taking a long-term view on achieving change by, for example, taking part in financial literacy courses taught in schools, colleges, and universities. The more the public understands that non-compliance with the tax system has a cost and that the general public

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<sup>39</sup> See: Odd-Helge Fjeldstad (2004), *Trust in Public Finance: Citizen's Views on Taxation by Local Authorities in Tanzania*, Project Brief LRG 12. The study supported the hypothesis that the rate of contribution to services is affected by factors such as citizens' trust in others and the trustworthiness of the government. Respondents agreed (51 percent) that people should refuse to pay taxes until the services delivered by government improved. A paper by Cummings, Ronald G. Jorge Martinez-Vazquez, Michael McKee, and Benno Torgler (2005), "Effects of Tax Morale on Tax Compliance: Experimental and Survey Evidence" found support for the hypothesis that tax compliance increases with individual perceptions that the tax system is fair and that the government is providing valued goods and services with the revenue.

must bear this cost, the more likely the tax administration will succeed in raising compliance levels. Over the long term, financial literacy can change attitudes and potentially contribute to a new tax culture that makes it socially unacceptable to evade taxes.

### Box 7.3. Lessons from CRA research involving younger citizens<sup>40</sup>

The Canada Revenue Agency (CRA) was interested in better understanding youth's levels of awareness about and attitudes towards taxation, and to identify any knowledge gaps relative to the subject. In addition, the CRA wanted to gain insight into potentially key messages that resonate with this segment of the population and the best vehicles for conveying taxation information to it. This study was conducted with youth aged 16 to 22 years old. To meet the research objectives, a total of twelve focus groups were conducted.

Findings suggested that youth have minimal awareness and understanding of income tax-related terminology. Youth also expressed limited knowledge of the requirements and processes involved in filing an income tax return. The findings highlighted the importance of informing and reassuring youth. Most importantly, youth need to be aware that they can potentially get overpaid tax refunded if they file a return, as this was deemed to be the greatest motivator. Parents, the Internet, and the telephone were considered the most useful means of accessing governmental information, while in-school presentations and print advertisement were deemed the most effective means of communicating simple tax information to youth.

## 7.2. Common Trends

Tax administrations are increasingly devoting resources to behavioral research, re-examining proven approaches to gaining compliance through the use of compliance certificates, and applying technology such as data mining that is being used to combat fraud in other areas of government and successfully adapting it to detect tax refund fraud.

### 7.2.1. Setting the Level of Sanctions

There is a considerable body of research into penalties for non-compliance. Theories concerning compliance can be categorized into three broad groups: 1) those that are based on economic theories which emphasize incentives; 2) those that are based on psychology theories; and 3) those that have a basis in sociology. Broadly, and rather simplistically, economic theory into tax non-compliance holds that, where a rational person sets out to be non-compliant, he/she will calculate the benefit to be derived against the marginal cost, plus the likelihood (risk) of being detected. Thus, the economic response, also simplistically summarized, is that the goal of imposing a sanction is that the threat, whether financial or otherwise, deters non-compliant behavior. Unfortunately, people are not always rational (in the context of economics), and the other theories place a more emphasis on psychological and sociological factors. These theories include the role of ethical, personal, moral, and social norms, as well as justice or fairness considerations, as strong determinants of taxpayer behavior.

This research into taxpayer behavior is a relatively new field. There is only a body of research<sup>41</sup> that spans about the past three decades. As such, tax administrations are still at the early stages of learning

<sup>40</sup> OECD (2010), p. 34.

<sup>41</sup> Australian Tax Office (n.d.), "Literature review: measuring compliance effectiveness 2007", <http://www.ato.gov.au/corporate/content.aspx?menuid=39508&doc=/content/00105122.htm&page=1&H1>.

and applying new approaches, and there is the tendency to use the more traditional and direct approach of sanctions when seeking increased compliance. So far with this body of research, there is not a conclusive approach to designing measures that will ensure that taxpayers will comply. Most studies and papers conclude that people are complex, and what may work for one set of persons in one circumstance does not work for others. Thus, a mix of approaches is necessary.

Where a tax reform is contemplated, compliance issues are usually cited as one of the reasons for the reform. In some situations, there is considerable pressure for the reform program to show results. New sanctions are rushed into law as a political response to poor compliance or to a specific situation that the electorate finds unacceptable. For example, the electorate may be incensed about a couple of large corruption cases, leading to a rushed amendment to confiscate all properties acquired with money through corrupt practices. The problem is, in the haste to draft the provision, assets that were purchased with money that was co-mingled with legitimate funds was not contemplated. Legitimate investors who had the misfortune of receiving some money from another investor who was found guilty of tax fraud had their investments seized. In this case, the sanction was overturned by the courts. In other situations, the sanctions could follow the traditional norms of a conservative group which may not be in step with modern practices. For example, look at the demographics of the country where a large percentage of the population is under the age of 25, while those preparing the law and sanctions are considerably older and may hold different values. One of the acceptable approaches when proposing new sanctions is to review the provisions of other laws in the country and also nearby countries to ensure that the proposed sanctions regime is synchronized, to a large degree, with the norms of these other laws. If it is radically different, then it may not be socially or politically acceptable, and it may not pass judicial review.

### **7.2.2. Tax Compliance Certificates**

Other civil sanctions that are used in some countries are the temporary suspension of business licenses to operate or the suspension of an accountant or other professional to represent clients in tax matters. This prohibition could be extended to doing business with the government or the ability to import goods through Customs. This latter sanction is generally used in conjunction with a tax compliance certificate scheme where importers must have a certificate from the tax administration to clear goods. The certificate generally must be renewed quarterly or at least semi-annually. A certificate would not be issued if there was an outstanding tax return or tax arrears.

There are disadvantages to suspending a license to operate or import. It is analogous to the former British system of debtors' prison, where people that could not pay were imprisoned until they could pay, but being imprisoned prevented them from earning the money to pay their debts. While the suspension is intended to be a deterrent, it may have the unintended effect of causing unemployment, damaging the economy, and further reducing the ability to the taxpayer to pay the original tax debt, while interest and penalty accumulates.



### 7.2.3. Refund Management Initiatives

Tax administrations have traditionally used computerization to identify non-compliance after a transaction has been completed. In many countries that have less sophisticated revenue systems, they rely on examining historical refund data to identify fraud cases for investigation after the refunds have been paid. In this scenario, tax administrations are using their scarce resources to chase frauds after they have been paid. These are cases that should never have been paid in the first place. Tax administrations should use the same databases to build models that are predictive and work in real time, to detect non-compliance before the refund is approved and payment is made.

Fraud, of course, is not unique to taxes. Other areas of government have recognized that fraud is becoming more sophisticated and that sophisticated tools to discover fraud are needed.

*"As fraud schemes become more sophisticated and migratory, access to real time data and the use of advanced data analysis to monitor claims and provider characteristics are critically important."*

Daniel R. Levinson, Inspector General, Office of the Inspector General, U.S.  
Department of Health and Human Services<sup>42</sup>

Advancements in data mining techniques present possibilities for quickly detecting unusual refunds that should be candidates for further investigation. Data mining to detect anomalies is different than modeling methods. Modeling is rule-based, where known frauds are examined to determine a set of rules which are stored, and the patterns of various refunds are compared to these rules to detect any similarities. Anomaly detection models store information on what normal behavior looks like, which makes it possible to identify deviations, even if they do not conform to any known pattern under the modeling method.

Another example of using data in real time is the use of sophisticated algorithms to predict an outcome, which is used very successfully by stock market investors in high frequency trading. A similar concept can be applied to identifying refunds that are suspect.

### 7.2.4. Automating Taxpayer Contact

Technology provides low cost options to fully automate the taxpayer contact process by, for example, sending text messages and e-mails directly to non-compliant taxpayers. The initial contact by text message and/or e-mail is brief and polite, but also gives a deadline for when the return is expected to be filed. This deadline would normally be about 5 working days. Taxpayers who are not covered by the LTO, but who have high risk or high revenue returns, are contacted after a suitable waiting time to allow for returns to be posted in the computer system (about 2 weeks). If the delinquent return has not materialized, then the case is escalated to the assigned tax officer to initiate telephone contact with the taxpayer. In the automated system, a log (diary) detailing dates and actions taken is maintained on the computer system. When the tax officer contacts the taxpayer by telephone, the date, time, the name of

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<sup>42</sup> <http://www.hhs.gov/asl/testify/2009/06/t20090625a.html>.

whom was spoken to, what was requested of the taxpayer, and the taxpayer response is recorded in this log.<sup>43</sup>

Tax administrations with the technological capability are also experimenting with web-based self-service solutions. In addition to being able to file a return online and make payments on their tax accounts, taxpayers can also view their tax account transactions and balance and view prior tax returns, and their registration information.

### **7.3. Tax Administration Maturity**

#### ***Filing and Payment: Maturity Level 1***

Key word: "Unfocused"

- Return forms use templates that vary by type of tax and contain insufficient information to determine liability. Returns are manually posted to ledgers and archived, but not otherwise analyzed (except when needed for other functions, such as audit). Only paper returns are used. Payments are accepted only at tax offices. Refunds are delayed and require budgetary appropriations.
- Complete tax return information is not captured electronically and cannot be used for analysis.
- There is no return verification (other than during audit).
- Filing, payment, and refund arrangements are separate for each type of tax and there is no standard.
- There are separate taxpayer accounts for each type of tax.
- There may be separate TINs issued by tax type.
- Electronic data if it does exist is unreliable. There are no guarantees of paper archive security as tax employees have unrestricted access to files.
- There is no stop-filer program.
- What few penalty provisions exist in the separate laws are vague or incomplete (e.g., penalties, but no interest).

#### ***Filing and Payment: Maturity Level 2***

Key word: "Burdened by processing"

- Returns contain sufficient information to determine liability, but continue to use templates that vary by type of tax. Returns are subject to an extensive annual review before it can be accepted as files and then sent for data capture and archived. Only paper returns are used. Payments through banks are allowed. Refunds are delayed and require budgetary appropriations.

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<sup>43</sup> When implementing an automated system similar to a log maintained on the computer system it is important that legal issues concerning the admissibility of the log in court are addressed in the event the taxpayer is prosecuted.

- Limited information is captured electronically (not enough to determine liability). Information is not captured as soon as practical (i.e., before computational verifications, audits, etc.) and there are inadequate system checks to ensure data integrity.
- Filing, payment, and refund arrangements are separate for each type of tax, and there is no standard.
- Although combined into a single revenue accounting system, taxpayer accounts continue to be separate for each type of tax with no coordination.
- There are some measures of security for paper archives, but measures for electronic data protection and disaster recovery are deficient.
- There is still no stop-filer program.
- There is a set of financial penalty provisions for various delinquencies, but they are insufficient and differ across taxes.

### *Filing and Payment: Maturity Level 3*

Key word: "Process-driven"

- Returns contain sufficient information to determine liability and use a standard template. Returns are verified, captured electronically, and archived. E-filing is allowed. Payments through banks are allowed. Refunds do not require budgetary appropriations, but are still delayed.
- Information sufficient to determine liability is captured electronically as soon as practical (i.e., before computational verifications, audits, etc.).
- Although standardized, filing, payment, and refund arrangements continue to be separate for each type of tax.
- Although combined into a single taxpayer accounting system, taxpayer accounts continue to be separate for each type of tax.
- Security of taxpayer data (both electronic and paper) is ensured.
- Stop-filers are identified and pursued, but in an ad hoc fashion as other priorities permit.
- There is a set of consistent financial penalty provisions, set at appropriate levels and covering all delinquencies.

### *Filing and Payment: Maturity Level 4*

Key word: "Program-driven"

- Returns and payments are standardized, expedited, and, where possible, e-filing and e-payment exist and are mandatory for large taxpayers. Returns are captured electronically, verified, and archived. Refunds are expedited through the use of a risk assessment process.
- Information sufficient to determine liability and support tax analysis is captured electronically as soon as practical.
- Taxpayers are offered a consolidated view of their tax account, combining all payments and returns into a single balance with the ability to offset refunds against other tax liabilities.

- Security of taxpayer data (both electronic and paper) is ensured.
- Stop-filers are systematically identified and pursued according to a well-defined stop-filer program.
- There is a set of consistent penalty provisions for all types of delinquencies (non-filing, non-registration, late filing, non-payment, late payment, etc.). These are set at sufficient levels to promote compliant behavior by taxpayers.

## 7.4. Latin America and the Caribbean

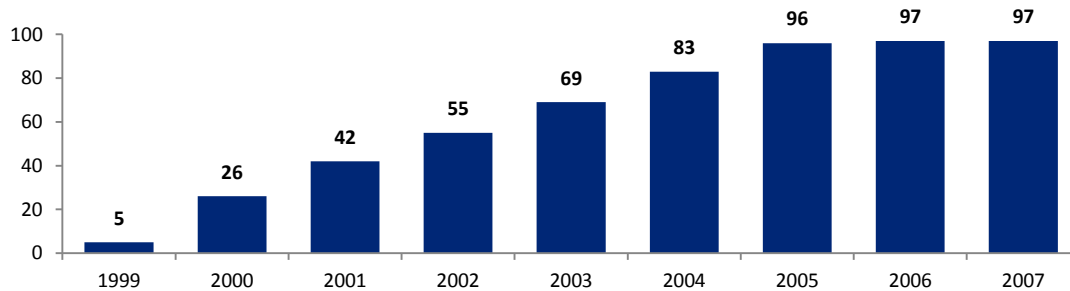
There has been substantial progress made in recent decades with regards to filing and payment systems in Latin America and the Caribbean (LAC). Standardized forms have been complemented with electronic filing and payment and information provided to the taxpayer to determine liability and assist in completing the forms. On average, tax returns filed through the Internet have grown rapidly and, in some specific cases, the Internet is the most reliable and accessible way to obtain forms and file returns. In countries such as Argentina, Brazil, Chile, Colombia<sup>44</sup>, Dominican Republic, Ecuador, Mexico, and Peru, electronic filing is virtually the only form of filing.

### Box 7.4. Over 97 percent e-filing in Chile<sup>45</sup>

The rapid growth of technology and internet services worldwide in the past decade has had a huge impact in terms of tax administrations providing e-filing services to taxpayers, but countries seeking to achieve 100 percent e-filing rates face several obstacles along the way.

Within LAC, the two leading countries in e-filing rates are Brazil and Chile. In the late 1990's, spurred by the technology boom and the Internet, Chile launched an effort to boost e-filing rates through large-scale investments in user-friendly systems, simplification of forms, and innovative initiatives to overcome connectivity issues. By 2007, the new public-private network established to combat sparse connectivity and costs accounted for nearly half of new e-filings. Aggressive marketing and awareness campaigns, combined with incentives to file online, significantly increased the e-filing rate in the country. E-filing was also made easier by improving access through agreements with internet cafes to allow taxpayers to file online at no cost, mobile units with computers, tax agents, and training operators.

**Trends in e-filing rates in Chile, 1999-2007 (Percent)**



<sup>44</sup> Colombia established mandatory electronic filing and payment for major taxes, including corporate income tax and value added tax (International Finance Corporation (n.d.), p. 6).

<sup>45</sup> Dohrmann et al., p. 14.

Progress has also been achieved in detecting and addressing delinquencies. In the area of stop-filing, computerization has allowed tax administrations in most LAC countries to improve control of stop-filers.<sup>46</sup> In some countries, tax administrations are working with police to combat refund fraud.<sup>47</sup>

Many LAC countries should be placed in the third or fourth level of the maturity model above. Nonetheless, many countries in LAC continue to struggle with cumbersome legislative frameworks, resulting in difficult compliance requirements.<sup>48</sup> Several countries have taken steps to overcome this challenge. In Brazil, a tax simplification scheme for microenterprises consolidated several taxes, reducing taxpayer costs and resulting in an increase in registrations with the tax authority.<sup>49</sup> According to the World Bank's 2012 Doing Business report, Mexico continued to reduce the administrative burden on businesses by eliminating some filing requirements for firms, including the obligation to file yearly value added tax returns, and Colombia allows the consolidated filing and payment of taxes levied on salaries.<sup>50</sup>

## 7.5. Key Benchmarks and Guidelines

Throughout the discussion of filing and payments presented in this chapter, several important topics and benchmarks have surfaced that should serve as key takeaways. The below list, while not exhaustive, attempts to summarize five major benchmarks and guidelines for filing and payments in the realm of tax administration.

- **Ensuring that the tax law, subordinate legislation, and penalty structure are sound public policy instruments.** This can be roughly gauged by the frequency of amendments to the returns and payments provisions of the law. Frequent amendments can be indicative of compliance issues that may be legal and/or administrative in nature (e.g., organization, process, procedural). Monthly statistics should be examined, as legislative problems will often be identified by tax officials during this general discussion. Both sanctions and interest should be automatic, with no discretion on whether they are applied, except in cases of hardship, where administrative discretion may be used on applications to reduce or waive sanctions.
- **Self-assessment is critical and can only function effectively if the taxpayer has sufficient information to accurately determine their correct tax liability.** A quick guide is to determine when the last amendment was made to a provision that affects either filing a return or paying tax and to locate the publication(s) that deal with these changes. The publication(s) should have

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<sup>46</sup> Tanzi (2000), p. 35.

<sup>47</sup> Brazil has taken significant steps to dismantle and publicize fraud. In March 2013, a nine-year-long investigation resulted in 31 incarcerations and the freezing of the assets of 195 companies and 62 individuals (Latin American Herald Tribune (2013), para. 13)). In February 2013, the Brazilian Federal Police in the state of Piauí issued five warrants to dismantle a criminal organization specializing in fraudulent individual income tax statements for obtaining refunds abuse. (Comunicação Social da PF no Piauí (2013), para. 1).

<sup>48</sup> In October 2012, the Latin Business Chronicle, after producing a Latin Tax Index based on World Bank, KPMG, and Heritage Foundation data, called a number of countries "small nightmares" and placed Brazil last (Latin Business Chronicle (2012)).

<sup>49</sup> Fajnzylber et al. (2011), p. 76.

<sup>50</sup> International Finance Corporation (n.d.), p. 5-7.

been modified to reflect the change in legislation shortly after the legal amendment. The tax administration should have a website with all current forms and publications available.

- **Filing and payment of returns should require minimal or preferably no contact with a tax official.** Ideally, payments should be made through the financial system and returns filed electronically.
- **There should be a unit dedicated to identifying and contacting stop-filers.** This may be further delineated by taxpayer size, with a special group dedicated to large taxpayers, although large taxpayers should ideally be 100 percent compliant when returns and payments are due.
- **There should be monthly statistics on returns and payments.** At a minimum, all large taxpayer stop-filers should be contacted within 14 days of the return becoming overdue. An aged report of receivables should be system generated each month, with the highest risk-to-revenue cases being allocated for action. A monthly management report should be produced by tax type that differentiates between large taxpayers and others and outlines the opening balance, intake of cases, resolved cases, and the ending balance for the period. The report should also have a brief, non-statistical analysis of events affecting compliance.

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# Appendix 7.A. VAT Refund Fraud

## *Types of Refund Fraud*

Briefly, there are several methods and schemes involving false identities and identity VAT frauds such as:

- Creating or stealing a person's identity for the purpose of submitting false claims for refunds and rebates (e.g., filing of false individual income tax returns using false information and documents);
- Using false and stolen identities to set up businesses with the sole purpose of committing income tax and VAT refund fraud. These false and stolen identities can be used to set up a business that appears to be legitimate with even a legitimate corporate registration with another branch of government;
- Creation of an identity on the basis of a stolen/fraudulently used passport or other major source of identification, such as the documents found in a stolen wallet or purse. This "acquired" identity is used to obtain a national identification number, which in turn is used for tax or business registration, opening bank accounts, printing invoices, etc.;
- Hijacking a taxpayer's identity by a tax officer, who then uses it to commit fraud; and
- Filing a claim by a tax officer for a person who does not exist, taking advantage of the system by staying under the various internal thresholds that would trigger an audit.

In the United States, the problem is growing where the IRS has identified the numbers of identity theft cases<sup>51</sup> that have affected the tax system: 51,702 incidents in 2008, 169,087 incidents in 2009, and 248,350 incidents in 2010. In 2012, the IRS listed identity fraud as the largest type of tax fraud, and, in 2011, the IRS intercepted more than \$1.4 billion<sup>52</sup> of tax refunds being paid out due to identity theft.

Identity theft cases occur because of:

- The inability of a tax administration to share information with other law enforcement agencies because of the confidentiality provisions of the tax law; and
- The elapsed time between paying a refund and identifying a fraud makes it difficult to find the perpetrator of the fraud.

Building on the false identity frauds described above, there is a potential for at least four different types of VAT refund fraud that can arise either with or without with the collusion of tax officials:

- In the least complex fraud, a fictitious company creates invoices from false, nonexistent, or fictitious suppliers, which are then used to request and obtain VAT refunds even though the company has not physically done anything at all;

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<sup>51</sup> GAO 2011, p. 2.

<sup>52</sup> Internal Revenue Service (2012), para. 9.

- A slightly more complex and harder to identify fraud is where a series of false companies are created. These false companies generate false invoices selling to each other and ultimately the goods are claimed to have been exported. When checking to ensure a supplier is registered, the auditor will see a valid registration, and even a good compliance history of returns filed on time;
- A bona fide company can purchase inputs or services without any tax invoices by negotiating a cash deal and thus avoiding paying tax on these inputs. The supplier suppresses the cash sale but claims the input tax. The purchasing company then uses false invoices from false, nonexistent, or fictitious suppliers with inflated tax amounts to request VAT refunds; and
- A bona fide company may buy goods or services but sell them in the domestic market instead of exporting them, while using the invoices to obtain VAT for exported goods.

"Missing trader fraud" builds on the above types of fraud and is probably one of the more prevalent forms of VAT fraud.

#### **Box 7-A.5. Missing trader fraud**

Missing trader fraud takes advantage of a structural flaw in the system of accounting for VAT. Importers are required to account for output VAT to the tax administration on their purchases from local traders. Exporters are able to reclaim input VAT paid on purchases, but are not required to account for VAT in respect of the goods exported, since these goods are zero-rated. If goods that are imported into a country are subsequently exported by a different person, the overall VAT position should be essentially neutral. However, perpetrators of fraud can exploit timing gaps in tax return and refund processes. Many administrations process and pay VAT refunds quickly, with some paying within 30 days of receipt, whereas for domestic sales it is frequently the situation that the return for any given month is due anywhere from 15 days following the close of the month, in which the taxpayer became liable to collect the tax, to a month later. If a taxable domestic sale was made on the first day of the month, the taxpayer has almost two months before it must be reported in many instances. This provides the opportunity to claim a refund as though the goods were exported, not remit the tax on domestic sales, and collect the full amount from the domestic customer before disappearing. This type of fraud can be a one-off using the bogus registration for a single, relatively large fraud (but still below the limits that would freeze the payment until an audit has been conducted), or it can be repeated for many months, with the fraudster disappearing only when the tax administration calls for records.

Unfortunately, the tax administration is generally late discovering a missing trader fraud. The refund(s) has been long since paid, and they may only just be in the early stages of notifying the VAT refund claimant that an audit is being conducted. Often, the suppression of taxable domestic sales not being reported goes unnoticed for a considerable period. The use of a false identity makes the fraud extremely difficult to trace.

All tax administrations face fraud. For example:

**Canada:** False and stolen identities have been used to set up businesses to commit goods and services tax (GST) fraud and to file false income tax returns to take advantage of refund programs under both taxes. Initially, the registration system for GST was lax, allowing a taxpayer to register over the telephone and, due to an overwhelmed system during the early years of the GST, the verification of these registrations was minimal. The Canada Revenue Agency has since instituted a series of internal verification procedures on registration applications.

**South Africa:** In a sophisticated and large fraud scheme, duplicates of well-known companies were set up with the Companies and Intellectual Property Registration Office (CIPRO). Bank accounts were then set up in the duplicates' names by individuals using fraudulent company and identity documents obtained from CIPRO. Members of the syndicate then hacked into the central South African Revenue Service (SARS) system. The bank account details of the legitimate companies were changed to those of the duplicates. When SARS paid out tax refunds these went to the accounts of the duplicate companies, not the real ones.

### *Fraud Detection*

Countries are devising methods to detect refund frauds and most use a combination of intelligence gathering, risk analysis, risk profiling, and data matching to detect cases of tax fraud. Fraud investigations are addressed in detail in Chapter 9, and the following are examples specific to refund fraud:

- Verifying the integrity of registration information against risk criteria, such as checking registered taxpayers that do not appear to have the income to start a business or appear too young to start a business;
- Using specialized database searches looking into relationships and commonalities between taxpayer accounts (addresses, phone numbers, banking details) and validating information with external databases;
- Carrying out computerized validity checks to identify duplicate returns or information that is repeated in other returns; and
- Profiling of known cases to identify the characteristics of the fraud and then searching the refund data for these characteristics (for example, a pattern in return filing).

Audit verification action will normally follow the lines of a conventional desk (in-office) audit/verification, although activity may be restricted to the refund in question. The credibility of the business operations itself should be examined, together with the documentation used to support the claim.

Some of the lessons learned in examining refunds are:

- The existence of an invoice does not prove that a transaction has taken place. It is important that tax auditors are satisfied that there is evidence of an actual transaction (e.g., contract, import/export documentation, settlement, bank deposits, *etc.*);
- There should be evidence of trading apparent. For example, if inventory controls show that goods came into stock, there should be evidence of a payment for the goods to the supplier. If materials in a manufacturing process are present, sufficient raw materials that roughly equate to the finished goods being claimed should have been exhausted, and the machinery should be capable of producing the goods;
- There should be evidence of involvement with Customs, including, in the case of exports, a letter of credit from the purchaser, shipping invoices from an independent carrier, bills of lading

from the transport company, insurance documents, mirroring import documentation for the country to which the goods were exported, such as the customs entry, and a customs broker invoice for services;

- There may be other supporting commercial documents besides the purchases and sales invoices, such as orders, warranty claims, insurance claims for damages, and inbound freight bills;
- Purchases, sales, and even employee payroll should be supported by bank statements, deposit slips, and cancelled checks;
- Transaction cross-checking to verify purchase and sales invoices should consist of sampling the largest transactions, repetitive transactions, and irregular transactions. Part of the verification should also test transactions with suppliers to verify VAT has been paid by the supplier. This cross-checking entails visiting the supplier and verifying their records to ensure that they match the details contained in the claimant's records.

Sometimes, due to the stringent controls banks now have as a measure against money laundering, once a bank account is set up, it will be used for multiple fraudulent businesses. This can be detected by simply running a query of the refund database or treasury listing for duplicate bank accounts.

Some countries do not process refunds centrally and various district offices process claims for their own taxpayers. Many tax administrations do not coordinate refund claimant information, and it becomes possible to lodge claims in different offices, in some cases only changing the address of the claimant. It is necessary to check the databases in the district offices for details that repeat in other offices.

### *Combating Refund Fraud*

The following are general guidelines.

- Refund procedures should use IT to check registration and payment information for anomalies, such as payments made into the same bank account number for different claimants;
- Refund claimants should be scrutinized according to risk criteria. As the administration becomes more experienced with risk assessment, the criteria should become more sophisticated;
- Where there is a reason for additional verification of a refund, the refund claim should be referred to a senior auditor/investigator for field audit;
- Field audits should be authorized for high risk refunds. In many instances, the tax administration lacks funds and logistical support which must be addressed; and
- Claims referred for field audit should not be subject to the same stringent time limits for processing and should be relaxed to allow for extra time, if necessary.

Where the checks on a questionable refund do not provide evidence to justify the refund claim, the tax auditor will need to consider the reasons. If the auditor is satisfied that there has been an unintentional error or a genuine misunderstanding, an audit assessment should be issued to bring the right amount of tax to account. In other circumstances, consideration should be given to the possibility of fraud. The

auditor making the examination must have received fraud training and be knowledgeable about the standards set for case preparation and for gathering and protecting evidence.

Combatting identity fraud requires changes in the way tax administrations process data. For example, before a refund of PAYE is authorized, the tax administration should require employer information returns to be submitted electronically on a regular basis, with this data being matched with tax returns before refunds are issued. This type of change would require improvements in the tax administration's automated processing systems and working with employers to implement this change.

### *Refunds – Identity Theft*

Refund fraud can occur when a thief uses a legitimate taxpayer's name and TIN to file a return claiming a refund early in the filing season, before the legitimate taxpayer files. The tax administration will issue the refund to the identity thief after determining the name and TIN on the tax return appear to be valid. The thief requests that the refund be paid into a bank account which is then promptly emptied and the thief disappears. The tax administration will only become aware of a problem after the legitimate taxpayer files a return and the computer system identifies that two returns have been filed using the same name and TIN.