NAO
National Audit Office
MALTA

Performance Audit

The Functions of the Tax Compliance Unit

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List of Abbreviations

DSS	Department of Social Security
GNP	Gross National Product
IRD	Inland Revenue Department
IT	Information Technology
NAO	National Audit Office
OECD	Organisations for Economic Co-operation and Development
TCU	Tax Compliance Unit
VAT	Value Added Tax

Executive Summary

1 Performance audit "The Functions of the Tax Compliance Unit (TCU)" was carried out during the period December 2004 to September 2005. This audit sought to assess whether:

i. the TCU's structure, plans, as well as communication procedures with the other tax collecting departments, assist in achieving Government's overall fiscal strategy.

ii. the data warehouse interface facilities (including benchmarks) at the TCU facilitate investigation.

iii. the TCU is generating additional tax revenue through investigation undertaken and tax agreements reached.

2. Various entities, including the Central Bank of Malta and the Social Partners voiced their concerns with regards tax compliance in Malta. The TCU featured in the national fiscal policy in circumstances where Government declared the intention of fiscal tightening to contain the deficit in the National Budget.

3. Under the Convergence Plan submitted to the European Union Commission, Government has committed itself to bring down the general government deficit to less than three percent of the GDP by 2006. One of the measures aimed at attaining the above targets is through increasing Government's receipts by enhancing tax enforcement and efficiency in tax collecting procedures. In this respect, Government's fiscal policy allocates an important role to the TCU through its investigative work related to tax avoidance and evasion, the collation of intelligence data about taxpayers, as well as establishing industry profiles.

4. A financial plan compiled during the setting up phase of the TCU, estimated that the Unit would generate revenue amounting to Lm2.7 million, Lm16.7 million, Lm28.4 million, Lm35 million and Lm43.7 million during the years 2000 to 2004 respectively. Such plans also envisaged that by end of 2004, the Unit would employ 96 persons. However, the TCU was not allocated the funds to employ the number of persons indicated in the financial plan and by the end of 2004 employeed 32 persons. Up to end of 2004, the TCU assessed additional tax liability amounting to Lm9.4 million.

The TCU's Structure, Plans and Communication Procedures

5. The TCU operates through the delegated authority of the tax revenue collecting and welfare payments departments, namely the Inland Revenue Department, the VAT Department, the Customs Department and the Department of Social Security. Thus, the TCU's every action regarding taxpayers must be sanctioned by the relative departments. The lack of a specific legislative framework has led to instances where the TCU's right to information was challenged from various quarters, including public and private entities, as well as associations on behalf of their members. This situation has been partly rectified through amendments in the Income Tax Management Act where the Commissioner of Inland Revenue can demand and receive any information in relation to the income or economic activity of any person or class of persons. Through 'delegated authority' this information would also be available to the TCU.

6. The TCU's Strategic and Policy Management Board has not met since April 2003. Consequently, the TCU's contribution towards enhancing the collaboration between the various departments responsible for collecting taxes or making welfare payments has been severely diminished. In addition, the Unit's operations have not benefited from any new strategic direction flowing down from its board.

7. The TCU's business plans did not indicate any quantitative targets regarding the number of investigations to be performed and the additional amount of tax revenue which was projected to be generated. This situation implies that the financial plan compiled during the establishment of the TCU was not considered by the Unit when drawing up its annual business plans. Admittedly, the TCU's workload is largely determined by tax collecting departments who refer cases for investigation. However, through discussions between the entities involved, quantitative targets could have been included in the Unit's business plans as instructed by the Chairman of the TCU's board in 2001.

The Tax Intelligence Database

8. The TCU has in its possession up to date information which facilitates the Unit's work and that of the tax revenue collecting departments to assess the tax liability of defaulters.

9. The integration of other databases available at other Governmental entities, may enhance the comprehensiveness of the TCU's data warehouse. In turn, this will enable the TCU to deal more effectively with its investigative work.

10. The TCU's data warehouse facilitates the generation of various information about taxpayers (such as asset profiles, VAT transactions etc.). Information from the data warehouse is also available on request to the tax collecting and social security departments. Whilst the TCU utilises this data for all of its investigative work, no requests for any information was made by either the Department of Social Security or the Customs Department by end of 2004. In addition, the number of requests for taxpayer profiles made by the Inland Revenue and the VAT Departments are significantly less than the number of investigations carried out by these Departments. It is to be noted that during 2005, the Department of Social Security requested 1,859 reports from the TCU's data warehouse.

Tax Investigations

11. The TCU carries out tax investigations on cases referred to it by the tax collecting or social security departments. From year 2001 till end of May 2005, the TCU concluded 174 investigations. Additional tax revenue assessed in respect of these 174 cases amounted to Lm6.58 million in income tax and Lm2.78 million in VAT. Tax investigations, generally, did not result in additional assessments for social security contribution since taxpayers investigated were already categorise in the highest contribution bracket. The TCU submits its investigation report to the IRD and the VAT Department for any follow up action these departments may deem necessary.

12. The TCU's set-up is more than adequate to cater for all types of tax investigations. The Unit employs professional accountants; it is supported by a tax intelligence database; and it performs its investigative work in accordance to generally accepted accounting standards.

13. However, the number of investigations which result in marginal assessments of additional income tax and VAT liability points to weaknesses in investigation targeting by the departments referring cases to the TCU. In turn, this situation results in expending costly TCU resources unnecessarily.

14. In 61 out of the 174 cases investigated (35 percent), no additional VAT assessments were instigated by the TCU as these cases generally related to VAT exempt business operations. A further 54 cases (31 percent) were assessed to have additional VAT liability of up to Lm2,000 per year under investigation. Only 20 out of the 174 cases investigated (12 percent) resulted in additional VAT assessments of Lm10,000 and over.

15. With regards to income tax, in 34 out of 174 cases investigated (20 percent), no additional tax liabilities were detected by the TCU. Moreover, 73 out of 174 (42 percent) of the investigated cases were assessed to have additional income tax liabilities of up to Lm5,000 per year under investigation. Only 14 cases out of the 174 (eight percent) investigated yielded additional income tax assessment of more than Lm30,000 per year investigated.

16. In 19 instances out of the 174 investigations (11 percent), no additional tax liability was assessed with regards to both income tax and VAT. Records maintained by the TCU indicate that in four cases the TCU's tax assessments would be absorbed by trading losses brought forward from previous years. In another four cases, the companies being reviewed ceased operations. In another four cases, the relative assessment raised was incorporated with assessments of other companies managed by the taxpayer under review. In the remaining seven cases nil assessments resulted.

17. On conclusion of the TCU's investigations, cases are referred to the VAT and the Inland Revenue departments for the necessary follow-up action. However, many of these cases are still outstanding as taxpayers often challenge the TCU's assessment.

18. Only 17 percent of the cases relating to the TCU's investigations concerning VAT have been fully settled. Taxpayers generally challenge the TCU's VAT assessments with some degree of success. Out of the Lm236,102 VAT liability assessed by the TCU with regards to the 23 cases that have been fully settled, the actual amount paid totalled Lm175,735 or about 26 percent lower than was originally assessed by the TCU. Moreover, the amount actually paid (Lm175,735) amounts to only 6.3 percent of the original Lm2.8 million VAT assessed. This state of affairs raises questions with regards:

- the TCU's investigation process itself;
- the robustness of the case as presented by the TCU; and/or
- the effectiveness of the follow-up process undertaken by the VAT Department with respect to the investigations in question.

19. Information relating to the current status of cases by the TCU concerning income tax was submitted in 133 out of the 174 instances. In the circumstances, the information presented in this report is on the basis of these 133 cases.

20. In addition, following the objection and appeal processes carried out by the IRD, the TCU's assessments regarding the 133 cases reviewed were revised downwards by 11 percent, that is, from Lm5,095,624 to Lm4,547,422.

21. As at end of May 2005, the IRD managed to recoup Lm491,877 out of the Lm4,547,422 revised TCU assessments following the objections and appeals process.

22. Full settlement following the IRD's follow-up of the TCU's assessments was effected in only 40 out of the 133 cases (30 percent). In 21 cases, although the objections and appeals process by the IRD had been concluded, no payment whatsoever had been effected with regards the Lm578,071 worth of additional assessed income tax liability.

23. 51 out of the 133 investigations are still in the objections and appeal process. Consequently Lm3,359,675 in additional assessed income tax remains outstanding. It is to be noted that 32 of these 51 cases have been in the objection and appeal process since 2003.

24. The TCU's cost-efficiency was not optimal. This was indicated by the TCU's average tax assessed per month of investigation and a comparison of the TCU's projected actual rate of return.

25. The highest average assessed VAT and income tax per month resulted in investigations which were concluded between four to six months. On average, investigations concluded within this time frame resulted in Lm2,675 and Lm7,740 VAT and income tax assessed per month of investigation respectively. However, the average duration for the conclusion of an investigation was 11 months. On average, investigations concluded in this duration resulted in Lm2,545 and Lm4,043 of VAT and income tax respectively.

26. For every Lm1 spent the TCU managed to assess additional tax liability of Lm7.47, Lm9.73 and Lm5.06 in 2002, 2003 and 2004 respectively. However, such returns are significantly lower than the TCU's projected expected return of Lm14.41, Lm22.93 and Lm28.22 for the years 2002, 2003 and 2004 respectively. The revenue projections discussed in paragraph 4 of this Executive Summary assumed that the TCU would have a staff compliment of 54 in its first year of operation, which would increase to 96 persons by 2004. Moreover, the revenue projections assumed that the TCU would start operating in 2000. However, the TCU was only employing 32 persons in 2004 and started operating in 2001. Consequently, the NAO was constrained to make some adjustments to the TCU's projected revenue in order to be able to obtain reasonable indications as to the TCU's cost efficiency on the basis of its rate of return.[1]

Turnover/Gross Income Benchmarks and Forward Tax Agreements

Benchmarks

27. In accordance with Government policy, the TCU developed 23 turnover / gross income benchmarks to determine the gross earning potential of small businesses and professionals operating in the services sector.

28. Government policy envisaged that the benchmarks, together with relevant information from other sources, will form the basis of implementing the Forward Tax Agreement Scheme. However, the TCU utilises these benchmarks as a starting point for work related to the Forward Tax Agreements.

29. Moreover, Government intended that the benchmarks are also used as an input by both the IRD and

[1] Such adjustments entailed that the TCU's projected revenue be adjusted by the Unit's previous year's Learning Curve Efficiency Factor. Further information is provided in paragraph 4.48 of this report.

the VAT Department in carrying out risk analysis of taxpayers' declared turnovers. To date this has not materialised.

Forward Tax Agreements

30. The TCU's success in the implementation of the Forward Tax Agreements was limited. The TCU managed to assess tax revenue amounting to Lm 2.6 million (Lm1.75 million in income tax, Lm402,075 in Social Security and Lm429,396 in VAT) over the three year period covered by the Forward Tax Agreements. These agreements were carried out with respect to three economic sectors. These business categories will be referred to as Sectors A, B and C throughout the report. The assessments generated by the TCU for the purpose of the Forward Tax Agreements amounted to an increase of circa Lm1.5 million in tax liability over the three year period prior to the Scheme.

31. The response by taxpayers eligible to participate in the Forward Tax Agreement Scheme was low. In fact, 67 percent of the eligible participants of Sector A, 38 percent of Sector B and 45 percent of Sector C did not show an interest to participate in the Scheme.

32. The Tax Compliance Unit reached 90, 45 and 63 Forward Tax Agreements with respect to Sectors A, B and C respectively. In addition, there were 56 agreements pertaining to Sector C which, during the time of this audit, were still in progress.

33. The assessed overall tax liability of those who signed the Forward Tax Agreement increased significantly as indicated hereunder:

- Prior to the agreements, the total tax liability declared per annum by signatories to the reement in Sector A averaged Lm1,580. Following the agreement the overall tax liability was assessed to average Lm3,285 annually – an increase of 108 percent.

- The assessed overall tax liability of signitories to the Agreement in Section B who signed the agreement also increased by 108 percent. The total tax liability declared per annum by each signatories increased from an average of Lm1,734 to Lm 3,601 annually after signing the agreement.

- The highest increase in the assessed overall tax liability following the signing of agreements was in Section C. The total tax liability declared per annum by these signatories increased from an average of Lm2,347 to Lm6,371 annually – an increase of 171 percent.

34. The Forward Tax Agreements tended to homogenise net incomes. This was particularly evident in Sectors A and B. With regards the former sector, 82 percent of signatories to the agreement were categorised in the Lm6,001 – Lm9,000 net income bracket. The latter sector grouped 64 percent of those who signed the agreement in the Lm12,001 – Lm15,000 net income bracket. However, due to the non participation in the Scheme of many eligible taxpayers, the overall impact on the participating economic sector was marginal.

35. The option of the TCU investigating taxpayers for the years prior to the signing of the agreement was forfeited by the tax revenue collecting departments.

36. A case study was carried out on the Forward Tax Agreements pertaining to Sector A. The following was revealed:

i. A comparison between the declared average turnovers for the 3 year period before the signing of the agreements with the average assessed annual turnover for the 3 year period following the agreements resulted in a 35 percent increase from Lm11,043 to Lm14,958. Such an increase, however, was still 17 percent below the average turnover benchmark established by the TCU.

ii. The TCU's policy stipulates that for Forward Tax Agreement purposes, the reviewing officers may accept turnovers / gross incomes which are within 20 percent of the established benchmark. Although on average turnovers were within this limit (17 percent), in 54 out of 90 cases (60 percent), this target was not reached.

iii. One of the drawbacks associated with the implementation of the Forward Tax Agreements is that the TCU did not devise any guideline with regards to the costs incurred by businesses.

iv. The level of costs agreed upon by the TCU and the taxpayers in Sector A was, on average, around 50 percent of the established turnover. This shows an improvement from the 60 percent which was previously being declared in the three years prior to the agreements.

Concluding Comment

37. Various quarters have sounded their concern regarding tax compliance in Malta. The Tax Compliance Unit was established to contribute towards the attainment of Government's fiscal objectives by increasing the tax revenue yield through enforcement.

38. The TCU is well equipped to carry out any type of tax investigation. It employs professional staff and has an up to date and comprehensive data warehouse at its disposal to support its investigative work. However, the TCU's net contribution towards increasing Government's net revenue yield was well below the expectations envisaged during the planning phases of the TCU. Since its inception, the TCU managed to assess an additional Lm9.4 million in tax liabilities following its investigative work. However, only a fraction of this amount has actually been collected to date. Moreover, the amount of additional tax assessed does not seem to correspond to the size of the informal economy. A number of reasons contribute to this situation.

39. The TCU operates through the delegated authority of the tax collecting and social security departments. Thus, the Unit has no authority or autonomy in targeting for investigations or enforcing the recommendations in its report. Such an operational framework implies that the TCU is generally reacting to the demands of the tax collecting and social security departments. Moreover, the TCU's effectiveness is also hindered since it lacks the general direction of its board. In the absence of board meetings, communication and coordination between the tax collecting departments and the DSS was weakened.

40. The data warehouse facilities at the TCU provide up to date information to support tax investigations. The opportunity exists for more information to be integrated with the data warehouse to further support investigative work. Although utilised by the TCU for all of its investigative work, the data warehouse is not being fully exploited by the tax revenue departments to, inter alia, enable them to target for a tax investigation those taxpayers who pose the highest risks to tax revenue.

41. Following the conclusion of investigations, many cases remain outstanding at the IRD and the VAT Department as most taxpayers challenge, with some degree of success, the TCU's assessment. Consequently, the ultimate aim of the TCU's work, that is, the full settlement of tax liabilities assessed, is only being marginally realised. In addition, the TCU's cost efficiency needs addressing.

42. The TCU also had contrasting results with the implementation of the Forward Tax Agreement Scheme. The concluded agreements managed to increase significantly the tax liability of participants to the Scheme, but were still below the TCU's own benchmarks. Moreover, the response by eligible taxpayers to the Scheme was low.

43. Given adequate support from its board and the co-operation of the tax collecting departments, the TCU can be in a stronger position to make a more notable contribution in not only ensuring that tax liability is fully realised, but also in instilling further a culture of tax compliance.

Recommendations

44. The National Audit Office proposes the following recommendations:

i. Meetings of the Strategy and Policy Management Board of the TCU resume as soon as possible. This would resolve outstanding issues provide the necessary strategic direction with regards to the TCU's operations and enhance the level of communication between the TCU and the tax collecting departments.

ii. The TCU's plans are to include quantitative targets relating to the number of investigations to be carried out and the assessed tax liability generated by the Unit. Other goals could be related to the Unit's cost-efficiency.

iii. Efforts are to be made to integrate the TCU's data warehouse with additional information available from Governmental entities to information would further support the TCU's investigative work.

iv. Tax collecting departments are to enhance their risk assessment when targeting cases for investigation by the TCU. This should contribute towards optimising the use of the TCU's resources by engaging the Unit in work that yields a high payback in terms of additional tax liability.

v. Tax collecting departments are to deal with the TCU's investigation reports in a more expeditious manner and maintain adequate management information in this regard.

vi. The Forward Tax Agreement Scheme needs revising. If it is to be maintained, it needs to be better publicised. Secondly, it must be clearly ascertained as to the extent that the turnover / gross profit benchmarks are to be utilised.

vii. Consideration is to be given in establishing costs benchmarks for the various economic sectors.

Chapter 1

Introduction

The Functions of the Tax Compliance Unit

Chapter 1 – Introduction

1.1 The performance audit: The Functions of the Tax Compliance Unit was undertaken during the period 1st December 2004 to 30th September 2005. The Tax Compliance Unit falls under the responsibility of the Ministry of Finance.

1.2 During 2004, revenue collected from income tax, social security and VAT amounted to circa Lm211 million, Lm190 million, and Lm142 million respectively. In total, this amounts to 67 percent of Government's ordinary revenue and 32 percent of Malta's gross domestic product.[2] In 2005, revenue collected totalled Lm586 million which amounts to 65 per cent of goverment's ordinary revenue and 30 per cent of Gross Domestic Product.

1.3 The primary goal of the tax revenue authorities is the collection of dues according to the law. Various quarters in Malta have voiced their concern regarding tax compliance. During 2004, the Central Bank of Malta also pointed out that it is a common knowledge that tax evasion is still widespread.[3]

Audit concerns

1.4 The EU Commission has noted that the Maltese Government can do more to address the current budget deficit problem stemming also from problems within the taxation system.

1.5 Figures extracted from Eurostat data 1995/2002 indicate that when compared to other member states averages, Malta was less effective in collecting its dues from the personal income tax segment. This viewpoint has already been expressed by Government itself.[4]

1.6 The Social Partners voiced their concerns regarding the fact that their members cannot be made to carry any more of the tax burden as a result of certain segments of the economy not being captured into a formal relationship of social responsibility vis-à-vis their tax liability.[5]

1.7 Although there is no official government data, the extent of the informal economy in Malta was estimated to show a progression from 8.4 percent in 1971 to 25 percent of the Gross National Product in 1997.[6] This estimate shows that Malta is only overtaken by Italy (from OECD Countries) whose informal economy was estimated at 26 percent of the GNP.

Government policy

1.8 Government's economic policy has the restoration of the country's public finances as one of its main objectives. The TCU featured in the national fiscal policy in circumstances where Government declared the intention of fiscal tightening to contain the deficit in the National Budget.

1.9 The structural deficit of the Consolidated Fund transactions stood at Lm44.7 million in 1995. This deficit was at its highest in 1998, where the fiscal imbalance amounted to Lm140 million and decreased to Lm94 million in 2004 (4.93 percent of the gross domestic product). In 2005, the fiscal imbalance totalled Lm75 million which amounts to 3.9 per cent of Gross Domestic Product.

1.10 Under the Convergence Plan submitted to the European Union Commission, Government has committed itself to bring down the general government deficit ratio to less than three percent of the gross domestic product. This document outlined that the general government deficit will go down to 3.73 percent of the GDP in 2005, decreases to 2.33 percent in 2006 and 1.41 percent in 2007. In this regard, tax revenue has been projected to increase to about

[2] Source: Financial Report of the Government of Malta 2004.
[3] Quarterly Review 2004:4 of the Central Bank of Malta.
[4] Joint Memorandum on Social Inclusion of Malta, EU Commission– http://www.europa.eu.int.
[5] Business Weekly, March 2000, Interview with Mr. Anton Borg, FOI President, 2004, http://www.businesstimes.com.mt/2003/12/31/interview.html.
[6] Cassar A. An index of the Underground Economy in Malta, featured in Bank of Valletta Review No.23, 2001.

Lm911 million in 2007 from the Lm739 million collected in 2003.

1.11 One of the measures aimed at attaining the above targets is through increasing Government's receipts by enhancing its tax efficiency and enforcement in order to curb tax evasion. In this respect, Government's fiscal policy allocates an important role to the TCU through its investigative work related to tax avoidance and evasion.

The Tax Compliance Unit

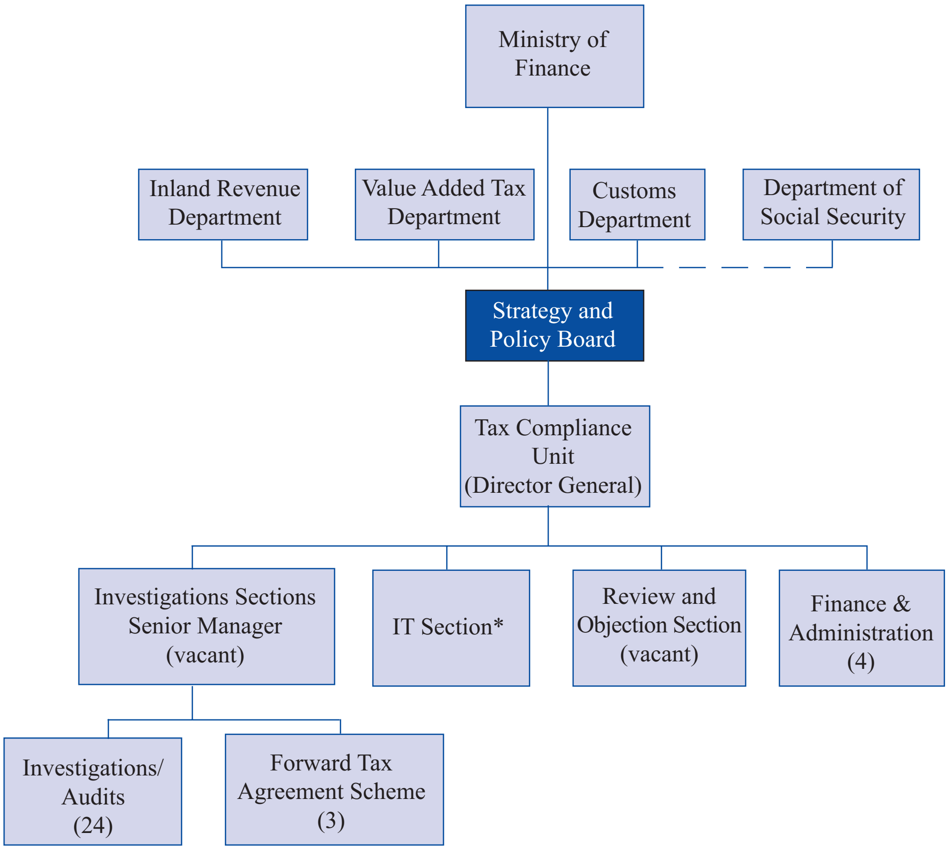
Background

1.12 The TCU was established by the Ministry of Finance in 2001, in order to support the main revenue earning and social security departments[7] in curtailing tax avoidance and evasion.

1.13 During its establishing phase it was projected that the TCU would generate revenue amounting to Lm2.7 million, Lm16.7 million, Lm28.4 million, Lm35 million and Lm43.7 million during the years 2000 to 2004 respectively. Such plans also envisaged that by end of 2004, the Unit would employ 96 persons.[8] A comparison between the projected revenue structure and actual additional tax revenue assessed by the TCU are presented in paragraphs 2.5 and 4.47 respectively.

1.14 The TCU was not established through any ad hoc legislative provisions but operates notionally under the VAT Act. It is funded through the VAT Department under the line item 'contributions to government entities'.

Figure 1.1 – Tax Compliance Unit Organigram



** Serviced by two persons from the Investigations Section on a part-time basis.*
Figures in brackets denote the number of staff allocated as at end 2004.

[7] The major revenue earning departments are: Inland Revenue Department (IRD), Value Added Tax Department (VAT), Customs and the Department of Social Security (DSS).
[8] Source: Inland Revenue Reengineering Task Force, Establishing of a Tax Compliance Unit.

1.15 The TCU's strategic policy is decided by the TCU Strategy and Policy Board. The board which is chaired by the Permanent Secretary Ministry of Finance, with the Head of the TCU, the Commissioners of VAT and IRD, the Comptroller of Customs, and the Director of Social Security (DSS) as members.

1.16 The Procedures Committee, established by the Strategy and Policy Board in 2001, set out the administrative terms of reference for TCU relations with the tax collecting departments. In addition, each department represented on the TCU Strategy and Policy Board has nominated a liaison officer to facilitate the flow of information between the TCU and their respective department.

1.17 The Unit performs tax assessments through the delegated authority of the Heads of the tax collecting and social security departments, as provided for in the relative legislation.

1.18 The set-up was intended to allow the IRD, VAT, Customs and the DSS to increase their own operational effectiveness by concentrating on their core competencies (processing the day-to-day returns, dealing with queries, revenue collection, issuing payments and other administrative operational aspects) whilst the TCU assists these departments in dealing with the larger and more complicated business entities (including performing tax investigations).

1.19 The Ministry of Finance considered that the tax revenue and the social security departments did not possess the necessary expertise (namely qualified tax auditors) to deal with the more complex cases or relative intelligence information about taxpayers.

1.20 The organigram at Fig 1.1 shows the general structure for collaboration between the tax collectors. Whereas the TCU (boxes at bottom of organigram) has been established to offer a database interface and a qualified investigation service, the focal point of the system would be the board in the middle of the organigram

Functions of the TCU

1.21 The TCU was set-up for providing specialised services to tax collecting and social security departments through:

1. Collating and maintaining information to facilitate tax investigations

The TCU maintains a data warehouse which integrates information held by various government departments and entities. This information is intended to facilitate the compilation of detailed taxpayer profiles (in terms of business activities and assets held), and any subsequent tax investigation. Information from the data warehouse is available on request to all tax collecting and social security departments.

2. Turnover/Gross Profit benchmarks

Up to end of year 2004, 23 turnover/gross profit benchmark studies have been concluded. These benchmarks relate to the main professional services, trades and other general personal services. Appendix 1 provides a list of benchmark studies carried out.

3. Conduct investigations on behalf of the revenue and the social security departments

The TCU carries out investigations on cases referred by the IRD, VAT, Customs and the DSS. It was agreed by the Strategy and Policy Board that cases to be referred to the TCU were to be the more difficult ones where substantial revenue under VAT or Income Tax was deemed to be at risk.

Up to end of May 2005, 174 cases were investigated. Assessed tax liability in respect of these cases amounted to Lm9,351,645.

4. Carry out Forward Tax Agreements with taxpayers on behalf of the tax revenue collecting departments

The Forward Tax Agreement Scheme was announced in the Budget Speech for 2002. The Scheme's primary objective is for the TCU to encourage taxpayers to enter into a three-year Forward Tax Agreement, thus establishing tax liabilities for the three years ahead. These Forward Tax Agreements are carried out by the TCU on behalf of the IRD and the VAT Department.

The Scheme is being implemented on a sector by sector basis up to 2004, 198 agreements were concluded in three economic sectors. The assessed tax liability in respect of the concluded agreements totalled about Lm2.6 million.

Audit focus and objectives

1.22 This performance audit focused on the operations of the TCU and the level of collaboration between the tax collecting and social security departments.

1.23 The objectives for this performance audit include evaluating the extent to which:

1. the TCU's structure, plans, as well as communication systems with other tax collecting departments assist in achieving Government's overall fiscal strategy.

2. the data warehouse interface at the TCU facilitates investigation.

3. the TCU is generating additional tax revenue through investigations undertaken and tax agreements reached.

Structure of the report

1.24 The following chapters cover the main issues addressed in this report:

1. chapter 2 discusses the TCU within the tax collecting structure and its level of communication with the main tax collecting departments;

2. chapter 3 relates to the comprehensiveness and the utilisation of the TCU's data warehouse;

3. chapter 4 discusses the TCU's main operations and results achieved through tax investigations;

4. chapter 5 focuses on the activities and results related to the Forward Tax Agreements;

5. recommendations proposed by the National Audit Office are included in the Report's Executive Summary on pages 10 and 11.

Chapter 2

The TCU's Structure, Plans and Communication Procedures

The Functions of the Tax Compliance Unit

Chapter 2 - The TCU's Structure, Plans and Communication Procedures

2.1 Government's fiscal strategy outlines the importance of increasing tax revenue through improved enforcement (vide paragraph 1.11). The success or otherwise of the TCU's contribution regarding tax avoidance and evasion is greatly dependant on its organisational attributes, business processes, as well as adequate planning.

2.2 This chapter discusses the TCU's:

1. organisational structure;
2. legal constraints;
3. business plans.

The TCU's organisational structure

Proposed versus current structure

2.3 The TCU's organisational structure is intended to facilitate tax investigations and to enhance collaboration between the tax revenue departments in order to minimise tax evasion.

2.4 Various differences exist between the current TCU's organisational structure and the structure as proposed in the Report *Establishment of a Tax Compliance Unit.* This Report was compiled by the Inland Revenue Reengineering Task Force, in November 1999. The proposed structure was to have a staff compliment of 54 in the first year of operation, which would increase 96 persons in 2004. In contrast, as at end 2004, the TCU employed 32 persons. Recurrent expenditure was to range from Lm798,800 in 2000 to over Lm1.2 million in 2004. However, the Unit's recurrent expenditure in 2005 amounted to Lm480,000.

2.5 Moreover, as indicated in paragraph 1.13, it was projected that the proposed structure would generate revenue amounting to Lm2.7 million, Lm16.7 million, Lm28.4 million, Lm35 million and Lm43.7 million during the years 2000 to 2004 respectively. The main differences between the current and proposed structure are depicted in Table 2.1.

2.6 The TCU explained these variances as follows:

1. the TCU's main priority was to establish its investigation section and gather information from Government entities to compile the Unit's data warehouse;
2. in addition, the TCU was never allocated the funds to implement the proposed structure. In fact, during the period 2002 to 2005, the TCU's recurrent expenditure budget decreased from Lm 670,000 to Lm480,000.

The TCU Strategy and Policy Board

2.7 The TCU Strategy and Policy Board chaired by the Permanent Secretary Ministry of Finance, and comprising of the Head of the TCU, the Commissioner of Inland Revenue, the Commissioner of VAT, the Director General Customs and the Director Social Security was established to:

1. resolve any data sharing difficulties between departments;
2. ensure that the Professional Secrecy Act is respected;
3. facilitate the work of the TCU.

Table 2.1 Comparison between proposed and current TCU's organisational structure

Proposed Structure	Implemented In Current Structure
Investigations	Yes
Legal Services (dealing with objections, appeals, court cases, legal interpretation, legal amendments, etc.)	No
Internal control (internal TCU audit, follow-up of customer complaints)	No
Information Management	Vacant (duties being carried out by two accountants on part-time basis). In October 2005, a team composed of TCU officials was established to evaluate both additional data sources that could be utilised by the TCU and other reports that could be generated from the data warehouse.
Quality Management (Finance and Administration, Policy and Manpower planning, Human Resources and Staff Training)	Finance and Administration only. The other duties were being carried out on part-time basis by the Office Manager and direct input from the Head TCU.

Source: Establishment of a Tax Compliance Unit (1999) and TCU Organisation Chart (2004).

2.8 The Head of the TCU sets an agenda with a direct input from the Chairman of the board. However, board meetings have not been held since April 2003. Consequently, any discussions regarding strategies and policies of the TCU have ceased completely. Thus, the board has not provided any management/strategic direction to the TCU.

2.9 During a review of the board's minutes and interviews with the members, the following issues arose:

a. Critical issues which were being discussed by the board remained outstanding. These issues included:

- whether the TCU should operate under some form of legislation;
- the TCU's accessibility to data held by third parties.

b. Board members representing the VAT and Customs Departments did not hand over responsibilities to their successors. Consequently, the current representatives of these departments were not in a position to answer the NAO's enquiries regarding the board's proceedings.

c. The board member representing the Department of Social Security participated only in meetings which related to the improvement of communications between his department and the TCU.

Communication between the TCU and other departments

2.10 In the absence of board meetings, communication between the departments represented in the board was weakened. This situation was not conducive to synergise the operations of the tax revenue departments and the TCU in order to improve Government's revenue flow – as was anticipated by the Chairman of the board.

2.11 Given that the TCU's board was not meeting, the Revenue Committee within the Ministry of Finance remained the only formal source of communication between the Departments and the TCU. However, the TCU's policies and strategies are not discussed in this Committee.

2.12 On a bilateral basis, the tax collecting departments (IRD, VAT and Customs) and the Department of Social Security agreed to appoint liaison officers to facilitate the flow of information between these departments and the TCU. Up to March 2005, neither the Department of Social Security nor the Customs Department had, at the time of this audit, liaison officers appointed. This situation is indicative of the peripheral role adopted by these two departments with regards the functions of the TCU. An improvement in this regard has been registered since a liaison officer representing the Department of Social Security was appointed in April 2005.

2.13 The sharing of tax 'intelligence' information between the TCU and the departments mentioned in the preceding paragraph will be discussed in the next chapter of this report.

Legal aspects

2.14 The TCU does not operate through any specific legislation but under the delegated authority of the tax collecting and social security departments. This implies that the TCU acts as a consultant for the tax collecting departments. In this role, the TCU actually conducts investigations and obtains information from taxpayers, using powers granted to the respective authorities under the respective laws.

2.15 However, the fact that the TCU operates under delegated authority has the following implications:

1. All investigations carried out by the TCU must be referred to it by the tax revenue or social security departments;

2. Since the TCU does not administer any legislation, the Unit cannot proceed beyond the stage of reporting its findings after concluding an investigation.[9] The issuing and collecting of tax assessments remains the responsibility of the department concerned. Furthermore, the TCU is not always informed as to whether the taxpayer accepted and settled the assessment raised by the TCU;

3. Due to lack of legislation covering the TCU, especially with regards to access and use of information, the Unit has been challenged by a number of private and public entities or associations on behalf of their members.

2.16 The Attorney General verbally advised the TCU that it is deemed more practical for the TCU to operate within an ad hoc legal framework. Such advice was offered in the light of the restrictions inherent in the VAT and the Income Tax Management Acts on the collection and exchange of information from and to third parties, as well as corresponding restrictions imposed by the Data Protection Act, in July 2002.

2.17 The legislative constraints mentioned above have been partly rectified in February 2005. Amendments to the Income Tax Management Act enable the Commissioner of Inland Revenue to demand and receive any information deemed fit in relation to the income or economic activity of any person or class of persons. Consequently, through 'delegated authority' such information would also be available to the TCU.

Planning

2.18 The TCU's business planning process was found to be deficient in the following aspects:

1. Business plans are not being reviewed by the TCU Strategy and Policy Board. The board is thereby forfeiting the opportunity to ensure that its strategy and targets are reflected in the Unit's business plans.

2. The TCU's three year rolling business planning lacked quantitative targets.[10] None of the business plans compiled during the period 2002–2004, forecasted the number of investigations to be carried out by the Unit or the additional revenue to be reaped by Government following the TCU's investigative work. In 2001, the Chairman of the TCU Strategy and Policy Board had issued instructions to compile work plans with targets. However, instructions were not followed. Furthermore, quantitative targets which were established during the setting up phase of the TCU (paragraph 2.5 refers) were not considered in the Unit's Business Plans.

3. Operational plans, stipulating schedules for tasks to be undertaken regarding investigations and other TCU activities are not compiled.

2.19 The following factors may have contributed to this situation:

[9] The exception to this scenario is when the TCU is requested by the department concerned to review its findings following a taxpayer's objection.

[10] The exception to this statement relates to the 2002 business plan where it was envisaged that about 20 to 24 investigation per professional accountant would be carried out annually.

1. The TCU's investigations workload is determined by the IRD and the VAT Department since these departments refer cases for investigations to the TCU. However, this issue could have been easily resolved through discussion between the entities involved.

2. The TCU Strategy and Policy Board has not met since 23 April 2003.

Conclusions

2.20 The TCU was established to contribute towards the realisation of Government's fiscal strategy by increasing the tax revenue yield through better enforcement. However, this chapter raises various management issues which impinge negatively on the TCU's contribution towards the full realisation of Government's fiscal strategy.

2.21 Operating through the delegated authority of the tax revenue collecting and the social security departments has hindered the TCU's activities since its establishment. The TCU's right to taxpayer information has been challenged from various quarters. As a service provider to the afore mentioned departments, the TCU has no authority or autonomy to target cases for investigation and to enforce recommendations made in its reports.

2.22 The TCU board has not met since April 2003. Consequently, the TCU's contribution towards enhancing the collaboration between the various departments responsible for collecting taxes or making welfare payments has been diminished. In addition, the Unit's operations have not benefited from any new strategic direction flowing down from its board.

2.23 Business planning shortcomings, particularly with regards to establishing quantitative targets for the TCU are not conducive to stimulate the Unit into operating at higher efficiency and effectiveness levels – that is, improving on its contribution towards Government tax yields through enforcement.

Chapter 3

Tax Intelligence Database

The Functions of the Tax Compliance Unit

Chapter 3 -Tax Intelligence Database

Introduction

3.1 One of the primary functions of the Tax Compliance Unit is to maintain a tax intelligence database in order to:

- support the TCU's investigative work;
- establish industry profiles;
- share information available with relative departments in order to minimise taxevasion and avoidance, as well as social security fraud.

Comprehensiveness of the data warehouse

3.2 The TCU has been compiling its data warehouse since 2001. The TCU has available various data, generally compiled by Government departments and entities. As at end of February 2005, the TCU's data warehouse integrated 13 databases whilst a further three were available to the TCU on-line. These databases provide information regarding various aspects about taxpayers, including business activities, ownership and involvement in the business, and assets held.

3.3 Most of the databases are integrated to facilitate the extraction of information regarding individual taxpayers or categories of taxpayers. For this purpose, the TCU utilises specialised querying software, which enables the generation of general and customised reports (vide paragraph 3.15).

3.4 In addition, the TCU can access other databases from Government entities on request. Generally, these databases provide information with regards to service providers.

Supplementing the data warehouse with other sources of information

3.5 The TCU has identified a further 19 possible sources of information that could be incorporated in its data warehouse. These databases would further facilitate the TCU's investigative work and analysis on economic sectors by providing additional information such as audit trails and assets held by taxpayers.

3.6 However, in five of these 19 instances, technical constraints (such as a lack of identity card numbers in the database) stalled the TCU's progress to integrate such information within its data warehouse. In one case, legal difficulties have not yet been overcome to enable the provision of data to the TCU. In the remaining cases, the TCU's progress to integrate the sources of information in its data warehouse was minimal. This is mainly due to the fact that the TCU's IT Section lacks the resources to perform such tasks.

3.7 Despite the number of databases available, the tax intelligence available does not fully cater for the TCU to deal with investigative work. Operational difficulties exist in establishing audit trails of certain service providers (especially in the case of professionals) due to limited information available.

3.8 However, various Governmental entities maintain databases relating to the licensing of various economic activities. These databases could aid the TCU in compiling hard evidence relating to business activities of service providers. In fact, during a meeting between the TCU officials and the NAO, a further 19 sources of information available in various Governmental entities were identified as potential additions to the TCU data warehouse.

Income declarations

3.9 As discussed in chapter 2, due to legal constraints, the TCU experienced various difficulties in attaining information regarding the economic activities of various sectors, particularly with regards to service providers.

3.10 The provisions of the Income Tax Management Act prohibit the TCU from holding information relating to taxpayers' declared incomes. The Inland Revenue Department only forwards such information to the TCU on a case by case basis (i.e. those cases selected by the IRD for investigation by the TCU). This scenario prohibits the TCU from analysing and utilising trends related to income declarations.

Utility of the data warehouse

3.11 The principal aim of the data warehouse maintained by the TCU is to enable the identification of taxpayers for investigation and to support related work. The TCU and other tax revenue collecting departments accessed/requested various reports to enable tax investigation work to be undertaken.

Supporting the TCU's work

3.12 All investigative work including Forward Tax Agreements performed by the TCU initiates with and is supported by the generation of information of the taxpayer's business activities and personal assets. In this regard, the TCU's data warehouse enables the Unit to form initial impressions about the case being investigated and to provide evidence (such as audit trails, assets, etc.) to support tax assessments raised.

3.13 The database offers integrated and referenced data which enables the generation of analytical reports identifying risks associated with:

- extensive assets acquisition across the whole population;
- inconsistencies between capital expenditure and income earning potential across the data subjects residing in the warehouse;
- inconsistencies in asset accretion within specific economic sectors;
- inconsistencies in operational ratios within specific economic sectors.

3.14 In addition, through the TCU's specialised querying software, the following analytical reports can be generated:

- identification of company shareholders;
- creation of company and company business profiles;
- specific tax avoidance schemes;
- company relationships in groups;
- vehicle value analysis;
- taxpayer profile summary;
- capital expenditure report on property transfers by individuals/companies.

Utility of the data warehouse by the tax revenue collecting and other departments

3.15 The TCU's data warehouse is also available, on request, to other Governmental entities, particularly the tax collecting departments. During 2004, the TCU generated 2,441 reports to the IRD, the VAT Department and the Employment and Training Corporation (ETC). Table 3.1 refers.

Table 3.1 Reports generated by the TCU for other Governmental Entities (2003-2004)

	IRD		VAT		ETC	
	Taxpayer Profiles	Vehicle Analysis	Taxpayer Profiles	VRN Enquiries[11]	Taxpayer Profiles	**Total**
2003	259	0	3	178	0	**440**
2004	323	270	30	1,323	495	**2,441**

Source: TCU.

3.16 Notes to Table 3.1:

- Taxpayer profiles relates to information regarding asset ownership, such as share capital, vehicles, vessels and property;
- Vehicle Analysis reports the value of vehicles owned by taxpayers;

[11] VAT Registered Number Enquiries.

- VRN reports are a means of ascertaining that businesses are properly registered for VAT purposes. This report matches the registration numbers of vehicles utilised for business (as noted by inspectors of the VAT Department) with the relevant VAT registration.

3.17 Table 3.1 reveals the following:

- The number of reports generated by the TCU for other Governmental entities during 2004 increased by 455 percent over the previous year;

- The 1,323 VRN enquiries (vide notes to Table 3.1) by the VAT Department constitute 54 percent of the reports generated by the TCU for other Governmental entities during 2004. The number of such reports generated in 2004 is about 643 percent more over the previous year;

- In 2004, 593 out of the 2,441 reports (24 percent) generated were for the IRD. 323 of these reports related to taxpayer profiles. However, it is to be noted that IRD requests do not usually reveal the purpose for which the information is required. Thus, the TCU could only provide generic information rather than generate a more in depth report regarding the specifics of particular cases.

3.18 Despite the number of reports generated by the TCU for other Governmental entities, particularly the tax collecting departments, there is still more scope for increased utilisation of the TCU's data warehouse.

3.19 This situation can be observed when the number of new cases targeted for a tax investigation by the IRD and the VAT Department in 2004 were compared to taxpayer profiles generated by the TCU for these departments during the same period. During 2004, the IRD requested 323 taxpayer profiles when the number of new cases targeted for investigation amounted to 1,467. During the same period, the VAT Department targeted 234 new cases for investigation but the Department only requested 30 taxpayer profiles.

3.20 It is to be noted that the Customs Department and the Department of Social Security have by end of 2004 not raised any requests for information from the TCU's data warehouse. Moreover, the officials interviewed from these Departments were not fully aware of the information available at the TCU. Such a situation prohibits the above mentioned departments to upgrade their own in-house databases with information available at the TCU.

3.21 An improvement of the situation discussed in the preceding paragraphs has materialised since during 2005, the TCU generated 3,293 reports on behalf of other Government departments. 1,859 of these reports (56%) were compiled on behalf of the Department of Social Security.

Information sharing

3.22 Access to the data warehouse is limited to the TCU's senior accountants and the Head of the TCU. The tax revenue collecting departments do not have on-line access to the database.

3.23 This situation is considered as a stumbling block to the notion of disseminating information maintained in the TCU's data warehouse. Electronic access (with strictly enforced access controls) would facilitate and enhance the work of the tax revenue collecting departments, particularly when carrying out risk assessments of taxpayers.

3.24 Information sharing between the TCU and the other tax revenue collecting departments is also hindered since generally, the TCU has not taken a proactive approach and generated reports under its own steam for transmission to the relevant departments. Instead, the TCU has generally reacted to requests for information from the departments.

Conclusions

3.25 Since its establishment, the TCU has endeavoured to collate information which contributes towards the identification of tax defaulters and to subsequently deal with such cases.

3.26 The TCU has in its possession up to date information which facilitates and supplements tax investigative work. The integration of other databases available at other Governmental entities could further enhance the comprehensiveness of the TCU's data warehouse. This would permit the TCU to deal more effectively with its investigative work, particularly with respect to service providers.

3.27 Information held at the TCU's data warehouse is not being fully exploited by the tax revenue collecting departments. This occurs because officials within these departments do not have adequate knowledge of the information comprised by the database.

Chapter 4

Tax Investigations

The Functions of the Tax Compliance Unit

Chapter 4 - Tax Investigations

Introduction

4.1 Another major function of the TCU is to perform tax investigations with regards to taxpayers or companies as referred to it by the revenue departments. Since its inception in March 2001, the TCU concluded 174 investigations yielding assessments of Lm6.58 million in income tax and Lm2.78 million in VAT.

4.2 This chapter will discuss:

- the investigations process;
- business sectors targeted for investigations;
- investigations undertaken;
- action taken by the relevant revenue departments following the TCU's investigative work.

The investigations process

4.3 It was intended that the TCU carries out tax audits on the more difficult and complicated cases as referred to it by the main tax revenue departments, i.e. the IRD, VAT Department, the Customs Department and the Social Security Department. The Head of the TCU may refuse cases which are considered to be within the competence of the revenue departments.[12]

4.4 The TCU performs its investigative work under the delegated authority of the Commissioner of Inland Revenue, the Commissioner of VAT, the Comptroller of Customs and the Director of the Social Security Department. The revenue departments operate under different legislations which regulate the investigations process. Consequently, the Unit requires covering delegation from each department concerned.

4.5 Before commencing an investigation, the TCU reviews the taxpayer's profile report[13] generated by the TCU's data warehouse.

4.6 The tax investigation commences after a meeting with the taxpayer, and the TCU obtains the required documentation of the business under investigation. The TCU's staff is guided through this process by a comprehensive manual and various checklists. The audit manual stipulates that during investigative work, the following has to be evaluated:

1. accounting ratios and their effect on the business being investigated before using them;
2. the work of the accountant of the business being investigated;
3. documents and books maintained by the organization under investigation;
4. what to look for at the business premises;
5. the businesses' computerized records and understanding the system;
6. hardware and accounting software;
7. support staff of the business under review.

4.7 Following the investigation, a report is compiled by the TCU, and is then submitted to the relevant revenue department. Generally, the investigation covers a period of more than two years.

[12] Minutes of meeting between the Head of the TCU and the NAO, 20 May 2005.

[13] Vide notes to Table 3.1 (page 27).

Table 4.1 – Breakdown by economic sector of investigations carried out by the TCU

Economic Sector	Number Of VAT Registrations In Sector [14]	Percentage Of VAT Registrations In Sector	Number Of Investigations Referred To TCU				%
			IRD	VAT	DSS	Total	
Agriculture, hunting and forestry	2,819	**9.39**	3	1	0	4	**2.30**
Fishing	320	**1.07**	0	0	0	0	**0.00**
Mining and Quarrying	67	**0.22**	0	0	0	0	**0.00**
Manufacturing	2,267	**7.56**	9	9	1	19	**10.92**
Electricity, gas and water supply	7	**0.02**	0	0	0	0	**0.00**
Construction	2,017	**6.72**	3	9	0	12	**6.90**
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	10,451	**34.83**	30	25	0	55	**31.61**
Hotels and restaurants	2,050	**6.83**	18	14	0	32	**18.39**
Transport, storage and communication	1,725	**5.75**	2	4	0	6	**3.45**
Financial intermediation	179	**0.60**	0	0	0	0	**0.00**
Real estate, renting and business activities	4,671	**15.56**	26	8	0	34	**19.54**
Education	350	**1.17**	1	1	0	2	**1.15**
Health and social work	192	**0.64**	5	0	0	5	**2.87**
Other community, social and personal service activities	2,405	**8.01**	1	1	0	2	**1.15**
Extra-territorial organizations and bodies	490	**1.63**	0	0	0	0	**0.00**
Nace Code Unavailable	0	**0.00**	3	0	0	3	**1.72**
Totals	30,010	100.00	101	72	1	174	100.00

Source: TCU and VAT.

[14] For the purpose of this comparison, 'A' registrations with the VAT Department were taken into consideration.

4.8 It is up to the revenue departments to decide as to whether or not to implement the recommendations of the TCU report. The issuing of tax assessments following an investigation, and the collection of taxes and penalties remains the function of the department on whose behalf the investigation was carried out. The taxpayer may appeal the result of the investigation with the department/s concerned in accordance with the provisions stipulated in the relevant legislation.

4.9 According to the Head of the TCU, the investigations process is hindered due to the following factors[15]:

- most taxpayers do not fully collaborate with the TCU;
- taxpayers often change their auditors after they are informed by the TCU that tax declarations are being investigated. This makes it harder for the TCU to obtain the required information;
- in certain instances, proper accounting records are only maintained after the investigation has been announced;
- penalties and fines imposed following the TCU's assessments are proving to be a disincentive for taxpayers to fully co-operate with the TCU.

Cases targeted for investigations

4.10 TCU performs its tax investigations on cases targeted by the revenue departments. From a total of 174 cases targeted for investigation during the period 2001 to end of May 2005, 101 cases were referred by the IRD, 72 cases by the VAT Department, and only one case was referred by the Department of Social Security. Table 4.1 refers.

4.11 The percentages of investigations targeted at particular business sectors were compared with the percentages of businesses in particular economic sectors registered with the VAT Department as at end of December 2004. The differences between the two variables under discussion indicate that the tax revenue departments considered certain sectors of the economy as potentially posing greater risks to tax revenue.

4.12 Wholesale and retail trade together with repair of motor vehicles, motorcycles, and personal and household goods was the TCU's most targeted business sector (31.61 percent of all inspections). This was followed by real estate, renting and business activities (19.54 percent of all inspections) and hotels and restaurants (18.39 percent of all inspections).

4.13 These sectors do not register a high value added. In fact, the value added for wholesale and retail stood at 11 percent whilst that for hotels and restaurants, and real estate/business activities was 6.6 percent and 12.9 percent respectively.[16]

4.14 The manufacturing sector produced the highest value added, at 21 percent. However, only about 11 percent of inspections were targeted at this economic sector.

Table 4.2 - Assessed tax following investigations

	No. Of Cases Concluded	VAT Assessed	Income Tax Assessed	Average VAT Assessed Per Case	Average Income Tax Assessed Per Case	Average Total Revenue Assessed Per Case	Total Tax Revenue Assessed
		(Lm)	(Lm)	(Lm)	(Lm)	(Lm)	(Lm)
2001	**7**	75,281	126,909	10,754	18,130	28,884	**202,190**
2002	**46**	482,990	1,609,406	10,500	34,987	45,487	**2,092,396**
2003	**51**	1,054,514	2,866,642	20,677	56,209	76,885	**3,921,156**
2004	**34**	252,645	815,493	7,431	23,985	31,416	**1,068,138**
2005[17]	**36**	910,547	1,157,218	25,293	32,145	57,438	**2,067,765**
Total	**174**	**2,775,977**	**6,575,668**	**15,954**	**37,791**	**53,745**	**9,351,645**

Source: TCU.

[15] Minutes of meeting between the Head of the TCU and the NAO, 20 May 2005.

[16] Malta's strategy for participating in economic and monetary union and adopting the euro, 2003.
[17] As at end of May 2005.

Investigations undertaken

4.15 This section focuses on the revenue assessed, in respect of income tax and VAT following the TCU's investigations. Table 4.2 shows that the investigations resulted in the following assessments.

4.16 Table 4.2 indicates that:

- The average revenue assessed per case declined by 60 percent in 2004 when compared to 2003. Moreover, the average of VAT assessed per case in 2004 was the lowest since the TCU commenced with its tax investigations;

- In addition, during 2004 the number of investigations concluded declined by a third over the previous year;

- As at end of May 2005, the average assessed revenue per case investigated increased by 83 percent over the previous year;

- No Social Security Assessments resulted. Such a situation mainly occurred since taxpayers were already categorised in the highest social security contribution bracket, and as such no adjustment to this rate was required. Moreover, in a few instances relating to cases where the taxpayer under investigation was deemed to have submitted erroneous or incomplete returns regarding the social security contributions of employees, the TCU included such assessments together with assessed income tax.

Assessed income tax following investigations

4.17 Table 4.3 depicts the assessed increases in income tax liability following the TCU's investigation.

4.18 The assessed income tax does not include any ensuing penalties, fines or interest. In addition, the assessed income tax pertains to the number of years subjected to the investigation.

Table 4.3 – Assessed income tax

Assessed Income Tax (Lm)	No. Of Investigations Referred By IRD	No. Of Investigations Referred By VAT	No. Of Investigations Referred By DSS	Total No. Investigations
0	18	15	1	**34**
1-10,000	29	27	0	**56**
10,001-20,000	16	6	0	**22**
20,001-30,000	11	6	0	**17**
30,001-40,000	4	5	0	**9**
40,001-50,000	3	1	0	**4**
50,001-60,000	1	4	0	**5**
60,001-70,000	2	2	0	**4**
70,001-80,000	1	0	0	**1**
80,001-90,000	1	0	0	**1**
90,001-100,000	2	1	0	**3**
100,001-110,000	2	0	0	**2**
110,001-120,000	1	2	0	**3**
120,001-130,000	1	1	0	**2**
130,001-140,000	0	0	0	**0**
140,001-150,000	1	0	0	**1**
Over 150,000	8	2	0	**10**
Total	**101**	**72**	**1**	**174**

Source: TCU.

4.19 Table 4.3 indicates that:

- The majority of cases (52 percent) were assessed to have an additional income tax liability of Lm10,000 or less. This amount includes 34 cases (about 20 percent of all cases) which did not result in any additional assessed income tax following the investigation;

- In about 10 percent of the cases investigated, the assessed additional tax liability for the period under review exceeded Lm100,000.

Assessed VAT following investigations

4.22 The TCU's investigations resulted in Lm2,775,977 VAT assessed in respect of the 174 cases reviewed. Table 4.5 categorises this amount in brackets of assessed VAT.

4.23 Table 4.5 indicates that:

- 61 cases out of 174 (35 percent) did not result in any additional VAT assessed. Most of these cases relate to instances where the taxpayer under investigation provides goods and services which are VAT exempt;

Table 4.4 – Average assessed income tax per year subjected to investigation

Assessed Income Tax Per Year Investigated (Lm)	No. Of Cases	%
0	34	19.5
1-5,000	73	42.0
5,001-10,000	26	14.9
10,001-15,000	10	5.7
15,001-20,000	6	3.5
20,001-25,000	5	2.9
25,001-30,000	6	3.5
30,001-35,000	1	0.6
35,001-40,000	2	1.1
40,001-45,000	3	1.7
45,001-50,000	1	0.6
Over 50,000	7	4.0
Total	**174**	**100**

4.20 The investigated cases were analysed in terms of the assessed income tax per year of investigation. It resulted that in 76 percent of the cases, the annual assessed tax liability was Lm10,000 or less. This amount comprises of the 20 percent of cases which were found to have no additional income tax liability following the investigation.

4.21 Table 4.4 indicates that:

- 73 cases (42 percent) pertained to the category where the additional tax liability assessed amounted up to Lm5,000 per year of investigation;
- only 11 cases (6 percent) were assesed to have an additional tax liability of Lm40,000 or more per year of investigation.

- a further 69 cases (39.7 percent) were assessed with additional VAT liability of up to Lm10,000;

- only 17 cases were assessed to have additional tax liability of Lm40,000 and over for the period under investigation.

4.24 When the investigated cases were evaluated in terms of VAT assessed per year of investigation, most of the cases (66 percent) resulted in assessed VAT of Lm2,000 or less. Table 4.6 refers.

4.25 Table 4.6 illustrates that only 12 percent of cases resulted in assessed VAT of more than Lm10,000 per annum.

Table 4.5 – Assessed VAT following investigations

Assessed VAT (Lm)	No. Of Investigations Referred By IRD	No. Of Investigations Referred By VAT	No. Of Investigations Referred By DSS	Total No. Investigations
0	50	10	1	**61**
1-5,000	20	25	0	**45**
5,001-10,000	12	12	0	**24**
10,001-15,000	2	6	0	**8**
15,001-20,000	3	3	0	**6**
20,001-25,000	3	2	0	**5**
25,001-30,000	0	1	0	**1**
30,001-35,000	3	2	0	**5**
35,001-40,000	1	1	0	**2**
40,001-45,000	0	2	0	**2**
45,001-50,000	1	2	0	**3**
Over 50,000	6	6	0	**12**
Total	**101**	**72**	**1**	**174**

Source: TCU.

4.26 The high number of cases which did not result in additional assessment coupled with the low number of cases which resulted in assessed VAT of over Lm10,000 further questions the investigation targeting process undertaken at the tax collecting departments.

Investigations resulting in no additional income tax and VAT liability

4.27 The preceding sections of this report (vide Table 4.3) showed that 34 out of the 174 cases reviewed by the TCU did not result in additional income tax. Furthermore, 61 cases out of the 174 cases reviewed did not result in additional liability regarding VAT. Table 4.6 refers

4.28 In 19 instances out of the 174 cases (11 percent) no additional tax liability was assessed with regards to both income tax and VAT. Table 4.7 refers.

4.29 Records maintained by the TCU indicated that the nil assessments with respect to both Income Tax and VAT resulted for the following reasons:

- In four cases, the TCU's tax assessment would be absorbed by trading losses brought forward from previous years;
- In four instances, the companies being reviewed ceased operating (including two cases where the taxpayers also absconded from Malta);
- In four cases the relative assessment was incorporated with assessments of other companies managed by the taxpayer under review;
- In the seven remaining cases nil assessments resulted.

Follow-up of TCU investigations by the tax revenue collecting departments

4.30 On completion, the TCU's reports regarding investigated cases are forwarded to the IRD and/or the VAT Department. These departments have absolute discretion to the extent of acting upon the recommendations put forward by the TCU. The taxpayer may review the assessment and raise an appeal in terms of the relevant legislation.

4.31 The NAO reviewed the outcome of the cases reviewed by the TCU at the VAT Department and the IRD.

Follow-up of the TCU's investigations by the VAT Department

4.32 The VAT Department only maintains an unofficial spreadsheet with regards TCU investigations. The VAT department was not in a position to clearly state which

Table 4.6 - Average assessed VAT per year subjected to investigation

Assessed VAT Per Year Investigated (Lm)	No. Of Cases	%
0	61	35
1-1,000	30	17
1,001-2,000	24	14
2,001-3,000	15	8
3,001-4,000	8	4
4,001-5,000	3	2
5,001-6,000	5	3
6,001-7,000	3	2
7,001-8,000	2	1
8,001-9,000	3	2
9,001-10,000	0	0
10,001-11,000	2	1
11,001-12,000	2	1
12,001-13,000	1	1
13,001-14,000	1	1
14,001-15,000	1	1
Over 15,000	13	7
Total	**174**	**100**

Source: VAT.

Table 4.7 – Investigations resulting in no additional tax liability

	Number Of Investigations Referred By IRD	Number Of Investigations Referred By VAT	Number Of Investigations Referred By DSS	Total Investigations	%
Investigations with zero assessment for both income tax and VAT	14	4	1	**19**	**11**
Total	**101**	**72**	**1**	**174**	

Source:TCU.

outstanding balances were being paid by particular payments made by a taxpayer, since the IT system utilised by the VAT Department does not cater for a detailed contra-entry system. Consequently, any conclusions reached by the NAO in this regard are on the basis of the unofficial database and the experience of the VAT/TCU liaison officer.

4.33 Out of the 174 investigations carried out by the TCU, 138 concerned VAT since the remaining cases related to VAT exempt business activities.

4.34 Table 4.8 raises the following issues:

Table 4.8 – Status of Processing of TCU investigations by the VAT Department (as at end of May 2005)

Processing Stage	Number Of Investigations	VAT Liability Assessed By The TCU (Lm)	Amount Due Following Revision By The VAT Department (Lm)
Full Settlement	23	236,102	175,735
Outstanding Payment(s)	60	1,518,202	1,188,749
Appeal	9	84,045	80,658
Review	46	937,628	495,060
Total	**138**	**2,775,977**	**1,940,202**

Source: TCU and VAT Department.

Table 4.9 – Status of Processing of TCU investigations by the IRD (as at end of May 2005)

	Number Of Investigations	Additional Income Tax Liability Assessed By The TCU (Lm)	Additional Amount Due Following The IRD' Review/ Objection / Board Process (Lm)	Difference Between TCU And IRD		Amount Settled (Lm)	Amount Outstanding (Lm)
				(Lm)	%		
Cases Concluded with full payment settlement	**40**	397,869	284,782	113,087	28	284,782	Nil
Cases Concluded but not fully paid	**21**	685,351	298,980	386,371	56	181,181	117,799
Cases Concluded but no payment has been effected	**21**	626,815	578,071	48,744	8	Nil	578,071
Not Finalised - i.e. Under Objection, Appeal, Within Objection Period or Appeal to the Board Refused by Commissioner	**51**	3,385,589	3,385,589	Nil	Nil	25,914	3,359,675
Total	**133**	**5,095,624**	**4,547,422**	**548,202**	**11**	**491,877**	**4,055,545**

Source: IRD.

i. Only 23 of the 138 cases (17 percent) have been fully settled. The VAT Department does not maintain information as to whether payments were made by taxpayers 'without prejudice' whilst still in the process of lodging an appeal on the assessment raised. Some taxpayers opt to settle assessments prior to their case being reviewed by the Board of Appeal in order to avoid payments of interests and penalties if the board's decision goes against them.

ii. The revenue collected in respect of the 23 cases that have been fully settled amounted to Lm175,735. This constitutes only 6.3 percent of the original Lm2,775,977 VAT assessed by the TCU.

iii. The TCU's original assessments relating to the 23 cases that have been fully settled were revised down during the review and Board of Appeal process from Lm236,102 to Lm175,735, that is, 26 percent of the TCU's original assessments.

iv. Table 4.8 indicates that the whole review and appeal process revised down substantially the TCU's assessments. This was particularly evident in the Review Process (the first stage of the appeal process). At this stage, the 46 review cases resulted in the TCU's assessments being reduced by about 47 percent, that is, from Lm937,628 to Lm495,060.

v. 60 cases (43 percent) have been fully processed by the VAT Department. However, taxpayers have not fully settled outstanding dues following the TCU's investigations.

vi. 46 cases out of the 138 (33 percent) were either at the Review stage or within the period that a taxpayer can request the TCU assessment to be reviewed. A further nine cases (7 percent) were being reviewed by the Board of Appeal.

4.35 The situation discussed in the previous paragraphs indicates that taxpayers are generally challenging TCU assessments with some degree of success. This raises questions with regards the robustness of the investigation and the case as presented by the TCU and/or the effectiveness of the process undertaken by the VAT Department with respect to the investigations in question.

Follow-up of TCU's investigations by the IRD

4.36 Information regarding the status of cases concerning income tax investigated by the TCU was submitted in only 133 out of the 174 cases investigated by the TCU. In the circumstances, the information presented in Table 4.9 provides a snapshot of the status of processing the 133 investigations by the IRD as at end of May 2005.

4.37 Table 4.9 indicates the following:

- Following the objection and appeal processes carried out by the IRD, the TCU's assessments regarding the 133 cases reviewed were revised downards by 11 percent, that is, from Lm5,095,624 to Lm4,547,422.
- As at end of May 2005, the IRD managed to recoup Lm491,877 out of the Lm4,547,422 revised TCU assessments following the objections and appeals process. The amount paid amounts to only 11 percent of the revised assessments.
- Full settlement following the IRD's follow-up of the TCU's assessments was effected in only 40 out of the 133 cases (30 percent). In 21 cases, although the objections and appeals process by the IRD were concluded, no payment whatsoever was effected with regards the Lm578,071 worth of additional assessed income tax liability.
- 51 out of the 133 investigations are still in the objection and appeal process. Consequently, Lm3,359,675 in additional assessed income tax remains outstanding. It is to be noted that 32 of these 51 cases (63 percent) have been in the objection and appeal process since 2003.

Duration of investigations

4.38 On average, it takes 11 months for a case to be concluded by the TCU, that is, from the time the investigation initiates to the time when the report is submitted to the tax revenue collecting department. Table 4.10 depicts the number of months spent by the TCU on investigations and the average VAT and income tax assessed per month of investigation.

4.39 Table 4.10 indicates the following:

- The highest average assessed VAT and income tax per month resulted in investigations which were concluded between four to six months. Consequently, this appears to be the most optimal duration for an investigation.

Table 4.10 - Duration of TCU investigations

Months At The TCU	No. Of Cases	%	Average VAT Assessed Per Month	Average Income Tax Assessed Per Month
0-3	6	3	1,014	5,368
4-6	39	23	2,675	7,740
7-9	46	26	2,476	4,362
10-12	25	14	2,545	4,043
13-16	33	19	375	1,065
17-21	16	9	1,203	3,149
22-24	8	5	1,597	7,161
Over 24	1	1	103	0
	174	**100**		

Source: TCU.

Table 4.11 – Comparison of the TCU's expenditure and tax revenue assessed (2002 – 2004)

Year	Expenditure (Lm)	Income Tax Assessed (Lm)	VAT Assessed (Lm)	Forward Tax Agreements[18] (Lm)	Total Tax Liability Assessed (Lm)	Ratio (Expenditure: Total Income Assessed)
2002	398,359	1,609,406	482,990	886,848	2,979,244	7.48
2003	452,930	2,866,642	1,054,514	486,174	4,407,330	9.73
2004	448,508	815,493	252,645	1,204,044	2,272,182	5.07
Total	**1,299,797**	**5,291,541**	**1,790,149**	**2,577,066**	**9,658,756**	**7.43**

Source: The Treasury, Financial Reports 2002 – 2004.

However, only 23 percent of investigations carried out were concluded within this period.

- Following a general decreasing trend, the average assessed tax per month increases again in investigations which duration is between 17 and 24 months.

4.40 These trends indicate that the payback, when delving deeper into investigations, may be lower than if a case was concluded earlier on existing evidence. However, the opportunity cost of aiming to maximise the average assessed tax per month of investigation is foregoing that each and every taxpayer's tax liability is fully determined.

Cost-efficiency of the TCU

4.41 The NAO sought to assess the cost-efficiency of the TCU by comparing its expenditure with the tax revenue assessed.

[18]Amounts quoted for Forward Tax Agreements assume that the Agreements with respect to sectors A, B and C were concluded in 2002, 2003 and 2004 respectively.

4.42 As discussed in Chapter 2, since it became operational, the TCU did not set any targets regarding the amount of cases that it is to review annually or the amount of assessed tax.

4.43 Between the periods 2002 and 2004, the TCU generated assessments amounting to about Lm9.7 million (including those related to Forward Tax Agreements). The TCU's total expenditure during this period amounted to about Lm1.3 million. On average, during the period 2002-2004, for every Lm1 spent the TCU assessed an additional Lm7.43 in tax revenue. Table 4.11 refers.

4.44 Table 4.11 indicates that in 2004, the TCU's rate of return was Lm5.07 for every Lm1 spent. This amount is about 32 percent less than the average rate of return (Lm7.43) attained during the period 2002 – 2004.

4.45 The TCU's rate of return was also compared with the revenue which was projected to be generated by the Unit. It was estimated that the TCU would generate

Table 4.12 – Comparison between the TCU's actual and projected rate of return

Year	Proposed Additional Assessed Tax Liability For Every Lm1 Spent (Lm)			Actual Additional Assessed Tax Liability For Every Lm1 Spent (Lm)
	Worst Scenario	Best Scenario	Expected Scenario	
2002	11.38	17.46	14.41	7.47
2003	18.17	27.54	22.93	9.73
2004	22.37	33.89	28.22	5.06

Source: Based on documentation reproduced in Establishment of a Tax Compliance Unit, 1999.

revenue amounting to Lm2.7 million, Lm16.7 million, Lm28.4 million, Lm35 million and Lm43.7 million during the years 2000 to 2004 respectively. These projections were based upon the estimated capital and recurrent expenditure, as well as the TCU's output.[19] The TCU's projected output took into consideration that a full time investigator should generate additional revenue on a successful case equal to at least four to ten times the costs incurred (that is, salaries plus a proportion of overheads). This approach enabled projections which assume the worst case, the best case and the expected scenarios to be computed. Moreover, the projected revenue to be generated took into consideration the Unit's Learning Curve Efficiency Factor.

4.46 The revenue projections discussed in the preceding paragraph assumed that the TCU would have a staff compliment of 96 persons by 2004. Moreover, the revenue projections assumed that the TCU would start operating in 2000. However, the TCU was only employing 32 persons in 2004 and started operating in 2001. Consequently, some adjustments to the TCU's projected revenue had to be made in order to be able to obtain reasonable indications as to the TCU's cost efficiency on the basis of its rate of return.[20]

4.47 Table 4.12 indicates that the TCU's rate of return was significantly below the revenue that the Unit was projected to generate. In fact, the actual additional assessed tax liability for every Lm1 spent by the Unit during the period 2002 – 2004 was even below the projected revenue to be generated by the Unit under a worst case scenario for the years in question.

Conclusions

4.48 The TCU's set-up is more than adequate to cater for all types of tax investigations. The Unit employs professional accountants; it is supported by a tax intelligence database; and it performs its investigative work in accordance to generally accepted accounting standards.

4.49 This chapter, however, indicated that in many instances cases being referred to the TCU for investigation by the IRD and the VAT Department resulted in either marginal increases or no increase whatsoever in assessed tax liability. This state of affairs points to inadequate risk analysis at the latter departments which is expending costly TCU resources unnecessarily.

4.50 The ultimate aim of the TCU's work is that assessments raised are settled by taxpayers at the relative tax collecting departments. However, many cases remain outstanding as most cases were appealed by taxpayers.

4.51 Moreover, tax liability assessed by the TCU was generally revised downwards indicating that either TCU's investigation process was flawed, and/or the TCU did not present a robust case, and/or that the tax collecting departments did not manage the review/appeal process effectively.

4.52 Indicators such as the average tax assessed per month of investigation and a comparison between the Unit's actual and projected rate of return imply that the TCU's cost efficiency needs addressing.

[19] The TCU's projected output was based on guidelines described by Keith Deacon in a report entitled 'Collection of Direct Taxes in Malta'.

[20] Such adjustments entailed that the TCU's projected revenue be adjusted by the Unit's previous year's Learning Curve Efficiency Factor.

Chapter 5

Forwarded Tax Agreements

The Functions of the Tax Compliance Unit

Chapter 5 - Forward Tax Agreements

Introduction

5.1 One of the main functions of the Tax Compliance Unit is to enter into Forward Tax Agreements on behalf of the Inland Revenue (IRD) and the Value Added Tax (VAT) departments. The main objectives of the Forward Tax Agreements are to simplify and streamline tax collection and enforcement with regards the small businesses (vide paragraph 5.17) or professional operators in the services sector. The TCU's work in this regard was to be supported by turnover benchmarks, which were devised by the Unit, in accordance with Government policy.

5.2 This chapter will discuss:

- the compilation and utility of turnover benchmarks by the TCU;
- response by taxpayers for the Forward Tax Agreement Scheme;
- the impact of Forward Tax Agreements.

Benchmarks

5.3 The primary objective of the benchmarking exercise was to determine the gross earning potential of small businesses and professionals operating in the services sector. The TCU embarked on this task between March 2001 and July 2001. To date, it has compiled benchmarks for 23 economic sectors, which can be categorised as professional, trades and services. A list of the 23 benchmarks compiled is attached at Appendix 1. As a policy the TCU Strategic and Policy Management Board decided not to publish benchmarks.

Compilation of benchmarks

5.4 The TCU's benchmarks are considered to reflect the average activity of a typical operator. The benchmarks, where appropriate, distinguish between leading or less leading operators as well as the locality in which the business activities are undertaken.

5.5 The benchmarks were subsequently reviewed by TCU commissioned consultants on the basis of:

- the acceptability of methodologies used;
- the plausibility of assumptions made by the TCU in the compilation of the benchmarks;
- the adequacy of information utilised;
- the comparability of the different approaches taken;
- the clarity and conciseness of the reports.

5.6 The Consultants' review led to some of the benchmark reports compiled by the TCU being edited, and where necessary turnover benchmarks were redefined.

5.7 In some cases, the TCU turnover benchmarks are broadly categorised and do not differentiate between different trades. Examples in this regard relate to automobile repairers' turnover benchmarks which comprise car mechanics, sprayers, and panel beaters. Electricians and plumbers are also categorised within the same turnover benchmark. This scenario diminishes the validity of turnover benchmarks, since the rates charged by the operators in different trades tend to be different.

5.8 By the end of December 2005, none of the 23 benchmarks have been revised in terms of inflation or other economic variables.

5.9 In addition, the TCU has not taken the initiative to compile benchmarks relating to other economic sectors. This situation prevails despite the fact that the TCU has additional information in its data warehouse which can be utilised in respect of various other service providers.

5.10 The TCU has, to date, no plans to compile any benchmarks relating to costs incurred by business operators. Consequently, TCU officials do not have any guidelines to refer to when assessing the correctness of costs declared or when establishing costs for Forward Tax Agreement purposes.

Utility of the turnover benchmarks

5.11 Despite the effort invested in the compilation of the turnover benchmarks, their use to date has been limited.

5.12 The TCU only utilises these benchmarks as a starting point in their work related to Forward Tax Agreements. The benchmarks are used to support the TCU's targeting of taxpayers in relation to this Scheme. In this context, taxpayers declaring a turnover below the benchmark were requested to accede to the Forward Tax Agreement Scheme.

5.13 The TCU does not make any further use of these benchmarks during its investigative work. The Unit maintains that benchmarks do not have significant utility in its investigative work since such work is performed on a case by case basis. This state of affairs does not reconcile with the intended Government policy that the benchmarks together with relevant information from other sources will form the basis of implementing the Tax Agreement Scheme.

5.14 Government policy in respect of benchmarks also envisaged that they will be used as an input by both the IRD and the VAT Department in carrying out risk analysis of taxpayers' declared turnovers. To date this has not materialised.

Forward Tax Agreements

5.15 The Forward Tax Agreement Scheme was announced in the Budget Speech for financial year 2002. The Scheme provides for taxpayers to enter into agreements with the IRD and VAT Department with respect to their income tax and VAT liability for the following three years. The Scheme is operated by the TCU under the delegated authority of the IRD and VAT department.

5.16 The driving force behind this Scheme was that the revenue departments were aware that certain categories of taxpayers, especially taxpayers in the services sector, pose the risk of under declaring business income and projecting an image of low economic activity. It was envisaged that the Scheme would be implemented through the application of sectoral benchmarks as guidelines.

5.17 The Forward Tax Agreement Scheme is intended for business operators with the following characteristics:

- self employed business operators providing services;
- self employed professional practioners;
- turnover or gross income of up to Lm50,000 annually.

5.18 Taxpayers who either refuse to participate in the Scheme or do not agree with the TCU regarding the tax liability for the next three years will have their case referred to the relevant revenue departments for a full-scale investigation.

5.19 To date, the Forward Tax Agreement Scheme has been applied to three sectors of the economy. Throughout this report these business categories will be referred to as Sectors A, B and C. The Scheme is currently being extended to other sectors.

5.20 The TCU entered into 198 agreements resulting in Lm2.6 million in income tax, social security and VAT assessments for the three year period covered by these agreements. Table 5.1 refers.

5.21 Table 5.2 illustrates the increases in tax liability with respect to income tax, social security and VAT. The highest increases in assessed tax liabilities were with respect to income tax.

5.22 Table 5.2 raises the following issues:

- There were no increases in the VAT liability for both Sectors B and C since the services provided are exempt from VAT;
- Social security assessments are based on the resultant net income of the taxpayer. There were

Table 5.1 – An overview of Forward Tax Agreements (2002 – 2004)

	Sector A	Sector B	Sector C
Full-time taxpayers eligible for the Tax Agreement Scheme	501	74	222
Agreements reached	90[21]	45	63
Assessed Income Tax liability for 3 years for all agreements concluded (Lm)	191,187	350,364	1,204,044
Assessed Social Security liability for 3 years for all agreements concluded (Lm)	266,265	135,810	nil
Assessed VAT liability for 3 years for all agreements concluded (Lm)	429,396	nil	nil
Overall tax liability effect for 3 years for **all agreements** concluded (Lm)	886,848	486,174	1,204,044

Source: TCU.

Table 5.2 – Increases in Tax Liabilities following Tax Agreements

	Sector A			Sector B			Sector C		
	Before Tax Agreement Scheme	**After Tax Agreement Scheme**	**% Change**	**Before Tax Agreement Scheme**	**After Tax Agreement Scheme**	**% Change**	**Before Tax Agreement Scheme**	**After Tax Agreement Scheme**	**% Change**
Social Security	172,293	266,265	55	113,044	135,810	20	/	/	/
VAT	203,238	429,396	111	/	/	/	/	/	/
Income Tax	51,076	191,186	274	121,049	350,364	189	443,617	1,204,044	171
Total	**426,607**	**886,848**	**108**	**234,093**	**486,174**	**108**	**443,617**	**1,204,044**	**171**

-

[21] In 8 cases, agreements reached involved partners. For the purpose of this exercise, these were taken as separate agreements.

no increases in the social security liability of signatories to the agreements pertaining to Sector C since, in most cases, their private practice operates on part-time basis. Consequently, in such cases, social security contributions are regulated through the full-time employment;

- Other instances for which no additional social security liabilities resulted following the tax agreement assessment, relate to cases where the taxpayer was already categorised in the highest contribution bracket. Such situations were evident for all three economic sectors participating in the Forward Tax Agreement Scheme.

Selection of sectors for Forward Tax Agreement Scheme

5.23 The primary consideration by the Strategy and Policy Management Board of the TCU in targeting particular sectors to participate in the Scheme was that the Unit should not be the subject of criticism itself for appearing to be 'singling out particular sectors for investigation by the Tax Authority'.

5.24 In fact, the board decided that a percentage of taxpayers from different economic sectors should be simultaneously reviewed for the purpose of the Scheme. This approach, however, gave way to a procedure where taxpayers within any one economic sector were being reviewed at any one time. The TCU explained that the reason for the change in approach was to enable assigned personnel to fully focus on one economic sector as this was perceived to yield better results.

5.25 The TCU had not drawn up or had at its disposal a risk analysis study relating to tax revenue risks posed by the various economic sectors. Consequently, the following was not taken into consideration when prioritising economic sectors to participate in the Forward Tax Agreement Scheme:

- the risk posed to tax revenue by the sector;
- the value added through the activities of the sector;
- historical sectoral compliance with the various tax laws/regulations.

Response by taxpayers to the Forward Tax Agreement Scheme

5.26 The taxpayers' response to the Scheme was low. In fact 67 percent (337 out of 501) of the eligible participants pertaining to Sector A did not show an interest to participate in the Scheme.

5.27 With respect to Sectors B and C, there were 38 percent (28 out of 74) and 45 percent (100 out of 222) respectively who did not show an interest to participate in the Scheme.

5.28 Generally, in the three sectors, it was the taxpayers who were declaring lower net incomes who opted not to participate in the Scheme.

5.29 Table 5.3 indicates that with respect to the Sector A and Sector C, the lower the degree of interest shown in the Scheme (not replying to the TCU's notice was deemed as the lowest level of interest), the lower was the net income declared.

5.30 In addition, eligble taxpayers in Sector B who were not interested in the Scheme also declared a lower net income than those who had shown interest.

Table 5.3 – Average of three years declared income prior agreement[22]

	Past Average Income Declared		
	Sector A	Sector B	Sector C
	Lm	Lm	Lm
Replied Yes, Agreement accepted	4,491	7,127	9,544
Replied Yes, Agreement not accepted	3,197	5,541	4,498
Not Interested	3,234	2,717	5,010
No reply	2,804	4,966	2,304

[22] Based on 858 cases out of 975 cases for which data was available at the TCU.

Concluded Forward Tax Agreements

5.31 The Tax Compliance Unit reached 90, 45 and 63 Forward Tax Agreements with eligble taxpayers in Sectors A, B and C respectively. These figures amount to 18 percent of taxpayers in Sector A, 61 percent of taxpayers in Sector B, and 28 percent[23]of taxpayers in Sector C eligible for the Scheme (vide Table 5.4). In addition, despite the work undertaken, the TCU failed to reach agreements with 82 taxpayers in Sector A, two taxpayers in Sector B and three taxpayers in Sector C.

5.32 The agreements yielded a total of Lm2.6 million in income tax, social security and VAT revenue for the three year period covered by these agreements. The overall tax declared by these sectors in the three years prior the agreement totalled to Lm1.1 million.

5.33 Table 5.4 indicates that in its assessments, the TCU had more than doubled the overall tax liabilities (i.e. income tax, VAT and social security contribution) of cases reviewed in respect of Sectors A and B, when compared to the revenue that had been declared by these taxpayers over the three years prior to the Scheme. In the case of Sector C, the assessed revenue following the agreements increased by about 171 percent.

5.34 This scenario points to a situation where the TCU had an adequately robust case to ensure that the taxpayer agrees to the TCU's assessments of tax liability. In addition, taxpayers were motivated to agree to their tax liabilities, as computed by the TCU, in the light that their previous tax declarations would not be subject to a review. Thus, by agreeing to the Forward Tax Agreements, these taxpayers would potentially be exempt from any tax

Table 5.4 – Concluded Forward Tax Agreements

	Sector A	Sector B	Sector C
Tax payers interested	172	47	66
Agreements concluded	90	45	63
Agreements not reached	82	2	3
Overall tax liability assessed for 3 years for **all agreements** concluded (Lm)[24]	886,848	486,174	1,204,044
Average overall tax liability assessed for **each agreement** for 3 years (Lm)	9,854	10,804	19,112
Average overall tax liability assessed effect **per annum** for **each agreement** (Lm)	3,285	3,601	6,371
Overall tax liability assessed declared by taxpayers in the previous 3 years (Lm)[25]	426,607	234,093	443,617
Average overall tax liability assessed declared by each taxpayer for 3 years (Lm)	4,740	5,202	7,042
Average overall tax liability assessed declared by taxpayer **per annum**	1,580	1,734	2,347
Total increase in overall tax liability assessed for the coming 3 years (Lm)	460,241	252,081	760,427
Percentage average increase inoverall tax liability assessed covered by agreements	108	108	171

Source: TCU.

[23]A further 56 cases are still in progress.
[24] Revenue effect in respect of Sector A, Sector B and Sector C are for the periods 2003-2005, 2004-2006 and 2005-2007respectively.
[25]Revenue declared by taxpayers in Sectors A, B and C are for the periods 1998-2000, 1999-2001, and 2001-2003 respectively.

liabilities and penalties that may otherwise have resulted had their past declarations been subjected to an investigation.

Net income

5.35 The Forward Tax Agreements reached have resulted in shifts in the income declarations of the taxpayers concerned. Table 5.5 refers.

5.36 Table 5.5 reveals that:

- Based on the average for the three years prior to the Forward Tax Agreement Scheme, about 87 percent of tax payers in Sector A used to declare a yearly income of up to Lm6,000 per annum. Following the agreement, the net income of most taxpayers in Sector A (82 percent) was deemed to pertain to the Lm6,001 – Lm9,000 bracket;

- Following the agreements, there was an upward shift in the net income declaration of taxpayers in Sector B. In fact, 64.4 percent of signatories to the agreement were categorised in the Lm12,001 – Lm15,000 income bracket. This contrasts with the 80 percent of taxpayers in this sector who for the three years prior to the Scheme, on average, used to declare a net income of up to Lm9,000;

- Similarly, income declarations of Taxpayers in Sector C also increased following the agreements. 75 percent of taxpayers in this sector used to declare a net income of up to Lm12,000 (based on the average for the three years prior to the Forward Tax Agreement Scheme). Following the agreement, 57 percent of thetaxpayers in Sector C agreed to a net income declaration of over Lm15,000.

5.37 The upward shift in the income declarations following the Forward Tax Agreements is also supported by the following factors[26]:

Table 5.5 – Shifts in net income declarations following Forward Tax Agreements

Incomes Bracket	Sector A				Sector B				Sector C			
	Declared Income Before The Tax Agreement Scheme		Declared Income After Tax Agreement Scheme		Declared Income Before The Tax Agreement Scheme		Declared Income After Tax Agreement Scheme		Declared Income Before The Tax Agreement Scheme		Declared Income After Tax Agreement Scheme	
	n	%	n	%	n	%	n	%	n	%	n	%
Loss	2	2.2	0	0.0	0	0.0	0	0.0	0	0.0	0	0.0
0 – 3,000	12	13.3	0	0.0	1	2.2	0	0.0	10	15.9	0	0.0
3,001 – 6,000	64	71.2	3	3.3	13	28.9	0	0.0	16	25.4	0	0.0
6,001 – 9,000	11	12.2	74	82.3	22	48.9	3	6.7	11	17.5	10	15.9
9,001 - 12,000	1	1.1	12	13.3	9	20.0	6	13.3	10	15.9	9	14.3
12,001 - 15,000	0	0.0	1	1.1	0	0.0	29	64.4	3	4.7	8	12.7
15,001 - 18,000	0	0.0	0	0.0	0	0.0	7	15.6	3	4.7	8	12.7
18,001-21,000	0	0.0	0	0.0	0	0.0	0	0.0	4	6.4	5	7.9
Over 21,000	0	0.0	0	0.0	0	0.0	0	0.0	6	9.5	23	36.5

Source:TCU.
n - relates to the number of cases

i. The annual average declared net income of taxpayers in Sector A prior to the agreements was of Lm4,491. This was increased to Lm8,326 after the agreements were concluded. This amounts to an increase of 85 percent on income declared.

ii. With regards to taxpayers in Sector C, the annual average declared net income of this sector prior to the agreement was of Lm9,544. This was increased to Lm20,214 after the agreement. This constitutes an increase of 112 percent on income declared. This indicates that the TCU may have been substantially more effective in increasing tax collection from this sector than from the taxpayers in Sector A.

iii. On the other hand, the average declared income of taxpayers in Sector B prior to the agreement was Lm7,127. Following the agreements, the declared income increased to Lm13,139 - an increase of 84 percent on net income declared. The TCU's performance in this sector was similar in relativity to results obtained with respect to Sector A.

iv. The Forward Tax Agreement Scheme tended to homogenise net incomes. This is particularly evident with respect to Sectors A and B, where 82 percent have been grouped in the Lm6,001 - Lm9,000 net income bracket and 64 percent in the Lm12,001 – Lm15,000 respectively.

v. The Forward Tax Agreements had different effects with respect to the net incomes of the three sectors under discussion. The net income of taxpayers in Sector A and C who used to declare a higher net income prior to the agreements had, on average, increased with a higher proportion than that of those who used to declare a relatively lower income. Chart 1 and 3 in Appendix 2 refers.

vi. On the other hand, the net incomes of the taxpayer in Sector B had, on average, shifted upwards with the same proportion irrespective of the level of income declared. Chart 2 in Appendix 2 refers.

Case study – Forward Tax Agreements pertaining to Sector A

5.38 The NAO reviewed the 90 Forward Tax Agreements that the TCU had reached with taxpayers in Sector A, particularly with regards to turnover and costs of the businesses under review. The agreed turnovers of taxpayers in this sector were also compared to the TCU's turnover benchmarks for this economic sector.

5.39 Generally, it was found that the TCU's work in this regard was well documented. taxpayer profiles, which were extracted from the TCU's data-warehouse were evident in all files reviewed. The taxpayer profile included the following information:

- assets held by the taxpayer;
- the number of people employed;
- business locality;
- previous income and VAT declarations (including profit and loss accounts submitted for income tax purposes).

Business turnover

5.40 Prior to the agreement, 57 percent of taxpayers in this sector (52 out of 90) who signed the agreement used to declare a turnover of less or equal to Lm10,000.[27] Following the agreement, the number of taxpayers who remained within this turnover bracket decreased to 38 percent. Chart 5.1 indicates that as a result of the Forward Tax Agreements, the turnover of the businesses involved increased.

5.41 The three yearly average of the declared annual turnover prior to the signing of the agreements amounted to Lm11,043. Following the agreements, the average turnover increased by 35 percent to Lm14,958.

5.42 However, such an increase is still about 17 percent below the average turnover benchmark originally established by the TCU.

5.43 Chart 5.2 indicates that in 67 out of 90 cases (74 percent), the agreed turnover was below the TCU's established benchmark for the business.

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[26]Average net income calculations are based on the three years prior and following the signing of the Forward Tax Agreement.

[27] Average based on the three years prior to the signing of the Forward Tax Agreement.

Chart 5.1 – Comparison of previously declared and agreed turnovers

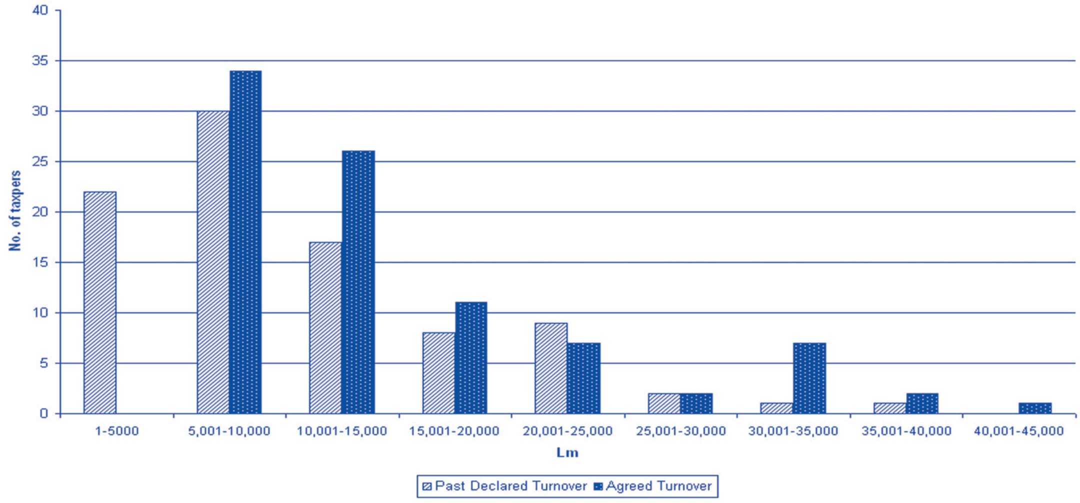
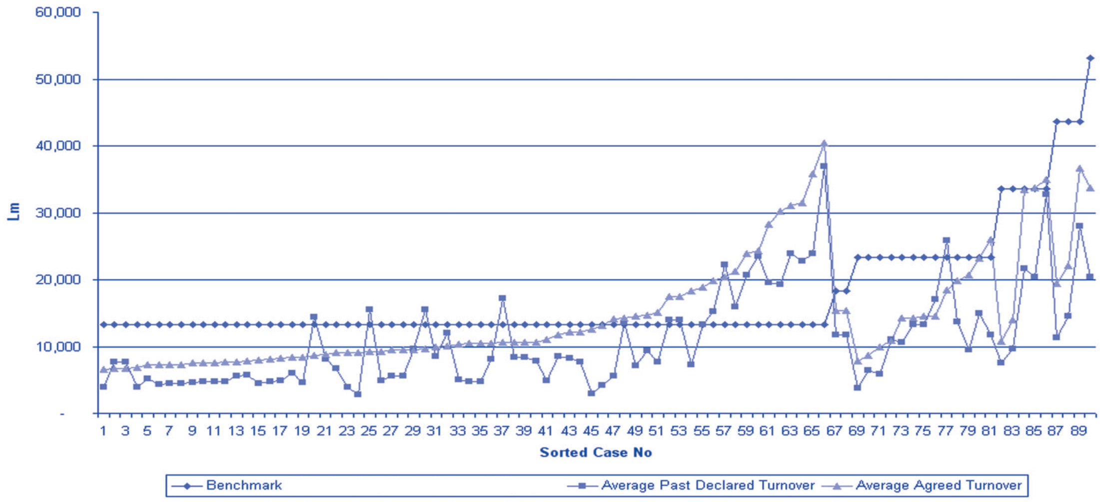


Chart 5.2 – Average turnover before and after the Forward Tax Agreement Scheme compared to the TCU's benchmark



5.44 The TCU planned that, for Forward Tax Agreement purposes, reviewing officers may accept turnovers/gross incomes which are within 20 percent of the established benchmark. Although on average, turnovers were within this limit (17 percent), in 53 out of 90 cases (60 percent), this target was not reached.

5.45 Despite the fact that the TCU utilises turnover benchmarks as an initial guide in work related to Forward Tax Agreements, chart 5.2 implies that the TCU was not in a position to negotiate and agree on turnover figures which were closer to its own established benchmarks. The TCU explained that such a situation occurred because the benchmarks are only being utilised as an initial guideline and that every individual case is dealt with according to its own merits.

5.46 It was envisaged that turnover /gross income agreed upon between the TCU and the taxpayer for the first year of the Forward Tax Agreement should be incremented between five to ten percent for both the second and third year of the agreement. However, turnover / gross income the second and third year of the agreement. When an inflation rate of circa three percent is taken into consideration, the incremental increase in the second and third year of the agreement was marginal.

Costs

5.47 One of the drawbacks associated with the implementation of the Forward Tax Agreements is that the TCU did not devise any guideline with regards to the costs incurred by businesses. The importance of costs guidelines stems from the fact that net incomes are dragged down due to the cost element associated with the relative business operations.

5.48 The NAO found that on average, costs agreed between the TCU and Sector C operators for Forward Tax Agreement purposes were around 50 percent of the agreed turnover (range of costs was from Lm415 – Lm31,046). This shows an improvement from the 60 percent which was previously being declared in the three years prior to the agreements.

5.49 However, with respect to taxpayers in Sector A, the average agreed costs for the three years covered by the agreement were 12 percent higher than the average costs declared during the three years prior to the agreement. Such an increase in costs was registered for two thirds of the taxpayers in Sector A investigated (61 out of 90).

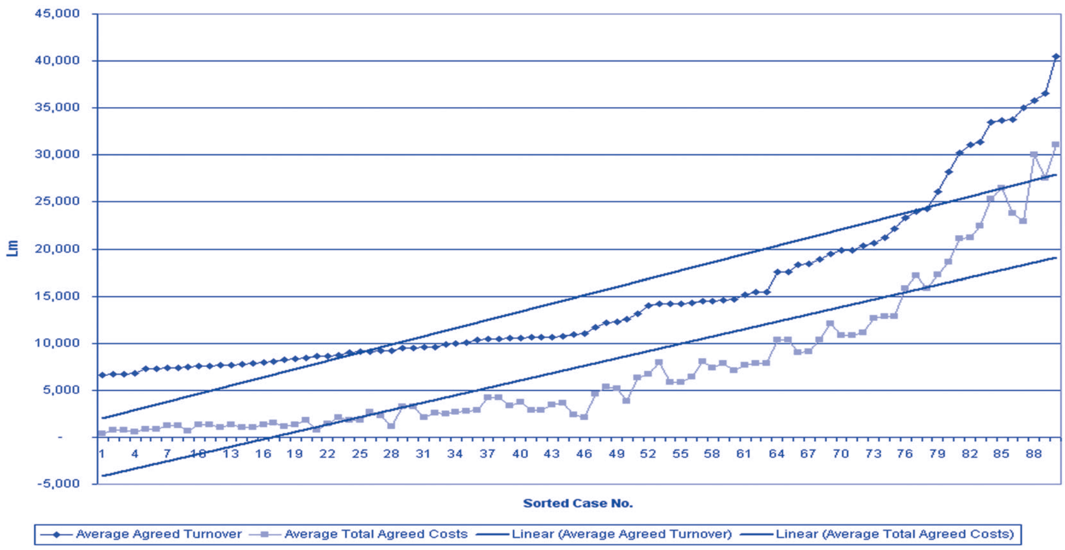
5.50 Chart 5.3 indicates, through the trend lines, that the TCU aimed at establishing costs as a proportion to agreed turnovers.

Conclusions

5.51 This chapter highlights the fact that the limited use of turnover / gross income benchmarks by both the TCU and other tax revenue departments, namely the IRD and the VAT Department does not adhere to Government policy declared in the Budget Speech for financial year 2001. Benchmarks were intended to aid the tax revenue departments target defaulters for tax audits, however, this has not materialised. Moreover, the TCU utilises the benchmarks only as an initial guide when conducting Forward Tax Agreements. These standards are not, however, utilised even as an initial guideline, when the TCU conducts its tax audits. Additionally, various institutions representing taxpayers within different economic sectors did not collaborate with the TCU in compiling sectoral turnover benchmarks.

5.52 The TCU assessed about Lm2.6 million in tax liability over a three year period covered by the Forward Tax Agreements. However, the TCU's success with regards

Chart 5.3 – A comparison of agreed costs with agreed turnovers



the implementation of the Forward Tax Agreements is regarded as limited.

5.53 The response by taxpayers to participate in the Scheme was low. Although the assessed tax liability of those participating in the Scheme had on average more than doubled, due to the non participation in the Scheme of many eligible taxpayers, the overall impact on the particular economic sector would be marginal.

5.54 The option of investigating taxpayers for the years prior to the signing of the agreement was forfeited by the tax revenue collecting departments.

5.55 In addition, the various internal parameters/targets, such as those associated with turnover benchmarks established by the TCU itself were not fully attained.

Appendix - 1

Benchmarks of economic sectors

Category	Sector	Sub-Sector
Professions	Accountants	Audit Firms Sole Practitioners
	Architects	
	Medical	General Practitioners Specialists Dentists Oculists
	Notaries	
	Private Tuition	
Trades	Construction	Drain Pipe Layers, Electricians and Plumbers Excavators Decorators Plasterers Masons Water Proofing Tile Lying Trenching
	Mechanics/Panel Beaters and Sprayers	
	Machine and Refrigerator Technicians	
Services	Black Taxis	
	Car Hire	
	Driving Schools	
	Goldsmiths/Silversmiths	

Appendix - 2

Shifts in net incomes following Forward Tax Agreements

Chart 1 : Comparison of Taxpayers in Sector A net incomes before[28] and after the Forward Tax Agreements

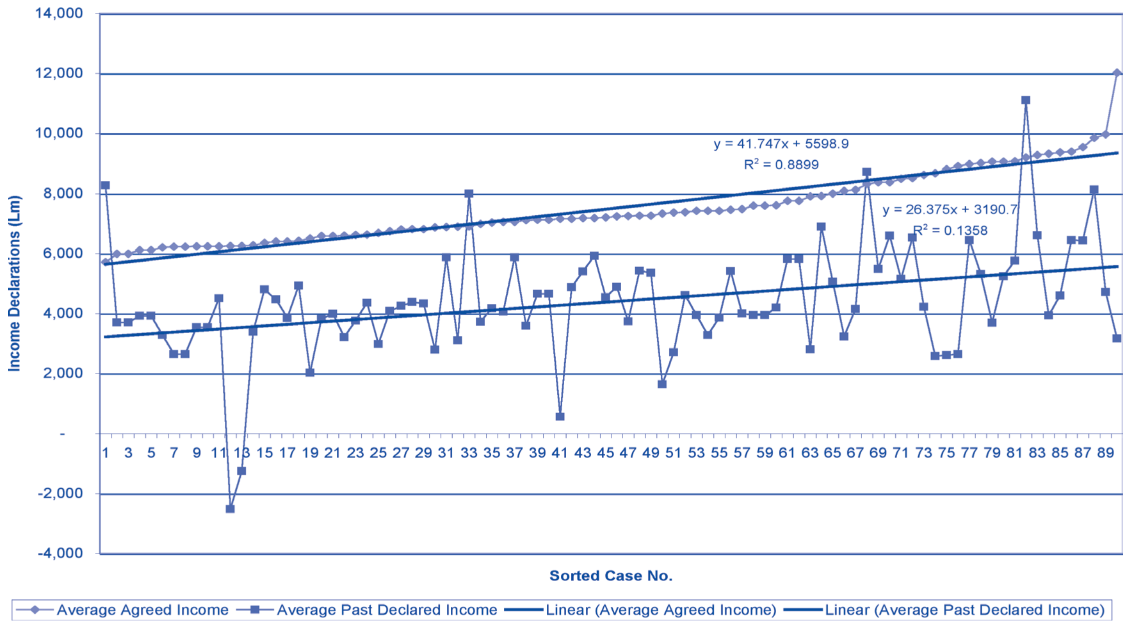
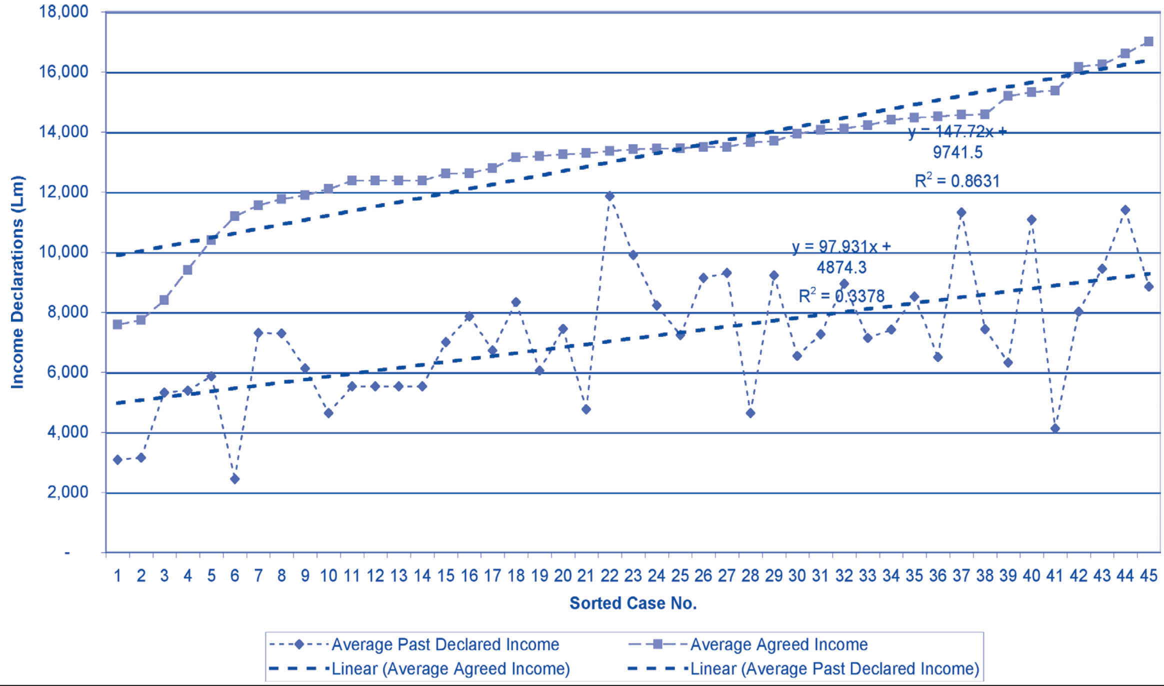
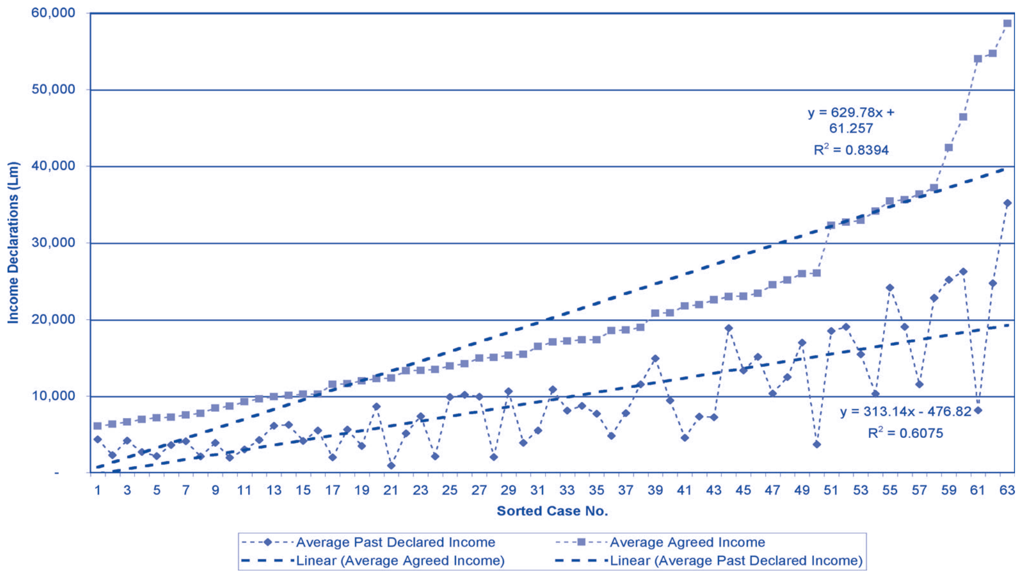


Chart 2 : Comparison of Taxpayers in Sector B net incomes before[29] and after the Forward Tax Agreements



[28] Based on the average of the net declared income for the three years prior the Forward Tax Agreements.
[29] Based on the average of the net declared income for the three years prior the Forward Tax Agreements.

Chart 3: Comparison of Taxpayers in Sector C net incomes before[30] and after the Forward Tax Agreements



The least squares fit for a line is represented by the equation $y = mx + c$, where m represents the slope or gradient of the line and c represents the y intercept.

The R-squared value represents how closely the estimated values for the trend line correspond to the actual data. The trend is most reliable when the R value is at or near the value 1.

[30]Based on the average of the net declared income for the three years prior the Forward Tax Agreements.