The Changing Tax Compliance Environment and the Role of Audit



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Preface

The Forum on Tax Administration (FTA) has been a driving force in developing thinking over the years about how to improve the effectiveness and efficiency of tax administration. This report, *The Changing Tax Compliance Environment and the Role of Audit*, should be seen in this context, setting out the changing landscape for both tax administrations and taxpayers and how these changes can be leveraged to enhance compliance, reduce burdens on taxpayers and build trust in the wider tax system.

Over the past several months, we have been looking at how compliance strategies are evolving in light of new technologies and tools, including new data sources and advanced analytics. The report looks at what that means for tax administrations, in particular regarding the role of audit and auditors which continues to be the largest part of most tax administrations. The survey that was done as part of this report concluded that tax audit will continue to play an important role in the compliance environment although that role is expected to look increasingly at wider tax system issues, including over time the robustness of the elements of emerging compliance by design systems. The report suggests that in the short term tax administrations may wish to refine their audit strategies and capabilities to help inform the wider mix of compliance activities. In particular more proactive and upstream activities will provide many opportunities for better tailoring of activities to taxpayer groups and individuals and better outcomes for taxpayers and tax administrations.

The developments that are facilitating these changes are a moving canvas and will require tax administrations to adjust and adapt their approaches constantly. Work by the FTA can help us in making these adjustments individually and collectively and I hope this report will provide tax administrations with a solid basis for future work.

I would like to thank everyone who has been involved in producing this report: the OECD Secretariat who worked closely with the Dutch team and contributed valuable insights, the Advisory Group that included revenue bodies from Canada, Hungary, Malaysia, South Africa, Sweden and the United States of America who have provided their constructive advice in

identifying areas of research as well as their indispensable expert reviews during the preparation on this report, all the FTA member administrations who contributed their time and expertise, and the team in the Netherlands who led the work. Together they have been the driving force in making this report a valuable document.

Jaap Uijlenbroek

Director General of the Netherlands Tax and Customs Administration

Foreword

Tax Administration of the Future Series

This report is part of the Tax Administration of the Future Series. All the reports in this Series have consistent themes around the use of data, changing customer expectations and the role of emerging technologies and look at the challenges and opportunities that these changes create for tax administrations. This report, *The Changing Tax Compliance Environment and the Role of Audit,* describes the mix of activities tax administrations have pursued in managing compliance and how this will change over time in light of developments in technology, including new tools and expanded data sources. In so doing, it considers the role that tax audit plays in supporting the effective operation of the dynamic and fast changing broader tax ecosystem.

Previous reports in this Series are:

- *Advanced Analytics for Tax Administration: Putting data to work* (OECD, 2016) provides practical guidance on how tax administrations are using analytics to support compliance and service delivery.
- *Rethinking tax services: the changing role of tax service providers in SME tax compliance* (OECD, 2016) looks at developments in the domain of tax service providers and explores how tax administrations can better co-operate with them to improve outcomes for SME taxpayers.
- *Technologies for better tax administration: a Practical Guide for Revenue Bodies* (OECD, 2016) explores how tax administrations can utilise emerging technologies to further enhance their electronic services. It also offers a framework for administrations to assess the maturity level of these services.

Methodology

The report was sponsored by the Netherlands Tax and Customs Administration in close co-operation with an advisory group and supported by the OECD Secretariat. A total of seven countries (Canada, Hungary, Malaysia, the Netherlands, South Africa, Sweden, and the United States) participated in the advisory group.

A survey to inform the report was completed by 29 countries (Austria, Canada, Chile, China (People's Republic of), Estonia, Finland, Germany, Hong Kong (China), Hungary, Ireland, Italy, Korea, Latvia, Luxembourg, Malaysia, the Netherlands, New Zealand, Norway, Poland, Portugal, Russia, Singapore, Slovak Republic, South Africa, Spain, Sweden, Switzerland, United Kingdom and United States). The survey elicited the views of tax administrations on how they expect compliance activities to change in the coming years including the role of audit.

In November 2016 a workshop with the advisory group and the OECD Secretariat was held in Utrecht, the Netherlands, which discussed the topics to be included in the report. In March 2017 a workshop of officials from countries which took part in the survey was held in Amsterdam to discuss the topics in more detail. Presentations were made by countries and external experts, including representatives of accounting firms and the Dutch Organisation of Co-operating Audit and Accounting Firms. Additionally as part of the project, tax directors, tax service providers and academics were interviewed to gain a better understanding of the current state of play and the expected future developments in the tax ecosystem.

Caveat

Tax administrations operate in varied environments. The way in which they each administer their taxation system differs in respect to their policy and legislative environment and their administrative practice and culture. As such, a standard approach to tax administration may be neither practical nor desirable in a particular instance. Therefore, this document and the observations it makes need to be interpreted with this in mind. Care should be taken when considering a country's practices to fully appreciate the complex factors that have shaped a particular approach. Similarly, regard needs to be had to the distinct challenges and priorities each administration is managing.

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Abbreviations and acronyms

APA	Advance Pricing Agreement
API	Application Programme Interfaces
AT	Autoridade Tributária e aduaniera (Portugal)
STAA	State Tax Administration Agency (Spain)
ATO	Australian Tax Office (Australia)
AW	Auditors' workbench programme
BASDA	Business applications software developers association
BEPS	Base erosion and profit shifting
CBC	Country by country reporting
CRS	Common Reporting Standard
ETCB	Estonian Tax and Customs Board
FATCA	Foreign Account Tax Compliance Act
FTA	Forum on Tax Administration
FTS	Federal Tax Service (Russia)
GBP	Great Britain Pound
GST	Goods and service tax
HMRC	Her Majesty's Revenue and Customs
HNTCA	Hungarian National Tax and Customs Administration
HNWIs	High Net Wealth Individuals
ICAP	International Compliance Assurance Programme
IR	Inland Revenue (New Zealand)
IRA	Italian Revenue Agency

IRAS	Inland Revenue Authority (Singapore)
IRSi	Internal Revenue Service (Ireland)
IRS	Internal Revenue Services (United States)
JITSIC	Joint International Tax Shelter Information Centre
MAP	Mutual Agreement Procedures
MOSS	Mini one stop shop
MLC	Multilateral control
MNE	Multinational enterprise
NTCA	The Netherlands Tax and Customs Administration
PAYE	Pay as you earn
PTA	Polish Tax Administration
RPA	Robotic process automation
SAF-T	Standard Audit File – Tax
SAT	State Administration of Taxation (People's Republic of China)
SFTA	Swiss Federal Tax Administration
SKAT	Danish Tax Administration
SME	Small and medium enterprises
STA	Swedish Tax Agency
VAT	Value added tax
XML	Extensible Markup Language

Executive summary

The environment in which tax administrations work is undergoing fundamental changes. This change covers not only what they do and the technologies they use, but also the dramatic increase in data sources and analytical capabilities, as well as the growth in third party providers. These changes are allowing tax administrations to rethink how they can best achieve their objectives of a high-level of taxpayer compliance and satisfaction, efficient tax administration and a reduction in burdens for taxpayers. This is leading tax administrations to reconsider their current mix of activities and in particular how a changed mix of service offering can produce better compliance outcomes.

More emphasis is being placed on proactive approaches, including co-operative compliance, the upstreaming of interventions closer to a taxable event, and compliance by design processes such as pre-filling of tax returns and trust-enhanced technologies. Significant challenges still remain in how best to respond to changes in working patterns and the potential impact on the tax base, how to best utilise and support external third parties and how and where burdens can be reduced.

Many tax administrations are already considering these issues, including the new capabilities they might require, and how the expectations of tax auditors will change over time. In particular, tax administrations report that they expect an increased emphasis on checks of the robustness of upstream process and compliance by design systems, including those provided by third parties, to sit alongside a stronger focus on high-risk taxpayers as well as combatting fraud and money laundering. The experience and knowledge of auditors to enable and support these moves while maintaining the integrity of the tax system will be of primary importance to administrators as they manage this change.

These developments take place against the background of changing taxpayer expectations as to levels and methods of service in line with wider developments in the use of new technologies and tools. They are also taking place at a time when tax administrations are implementing major changes to the international tax rules and reconsidering how they can best provide greater tax certainty to help facilitate investment and growth.

Budget constraints remain a significant pressure for tax administrations and it is important that there is an informed dialogue on the costs and benefits from the changes envisaged in this report which go far wider than the tax administration alone. A key consideration here is how measures that improve compliance levels and therefore the effectiveness of the tax system are developed and implemented.

The purpose and structure of the report

The report sets out how compliance strategies are evolving and can be expected to evolve in light of new technologies and tools, including new data sources and advance analytics. It also looks at how that is affecting the role of audit and auditors, which still represents the major share of the workforce for most tax administrations. Finally it suggests a number of areas where further work by the Forum on Tax Administration (FTA) might assist tax administrations in their consideration and implementation of reform.

Chapter 1 describes the current mix of compliance activities ranging from reactive to proactive, "upstream" and "compliance by design", the changes that are occurring and what they mean for tax administrations and taxpayers.

Chapter 2 provides an overview of the evolving compliance strategies and current priorities in managing compliance risk. Additionally, it describes a number of factors that are driving the changes in how tax administrations are seeking to manage compliance.

Chapter 3 looks at tax audit in a changing environment and identifies some areas where audit and the role of auditors might develop further as well as changes already underway.

Chapter 4 discusses the possibilities for greater international co-operation on risk assessment and multilateral audits. This chapter shares current experience on co-operation, looking at joint risk assessment, simultaneous tax examinations and joint audit.

Chapter 5 concludes with some final conclusions and recommendations.

Recommendations

As a result of the analysis in the report, a number of areas are recommended for possible future work:

- An overview note of what FTA members collectively see as the **core elements of tax administration and the expectations for developments** in the short and medium term in those areas. This will

be helpful in providing a framework for the development of internal strategies and as a guide to areas where future collective work would be of most value.

- **Supporting easier calculation of tax and more robust and upstream verification.** At the micro and SME business end, apps are already becoming available to reduce time spent on tax and the need for post-filing checks. A possible project on reducing the burden of calculating tax liability and reporting of relevant information could look at the different options becoming available for different categories of taxpayers and how tax administrations could best support them. This could include for example supporting standard setting, the use of third party software and the facilitation of third party apps. There may also be value in further collaborative work on the standard audit file for tax (SAF-T) as to how it can potentially substitute for the tax return or provide a clearer underpinning to tax returns, including how it fits with evolving systems used by business.
- **As regards audit developments,** there could be value in sharing tax administration's experiences with regard to system assessment processes that are currently used. In addition, given that different approaches are taken by tax administrations in regard to random audits, it could be useful to share experiences with regard to the costs and benefits of random audit programmes.
- **Co-operative compliance**. As a number of administrations report their interest in expanding these frameworks and approaches, it could be worth looking at the lessons to date of co-operative compliance programmes and how to ensure that they are delivering their aims without imposing excessive burdens. Guidance could also be helpful on how co-operative compliance programmes could operate for small and medium-sized enterprises (SMEs).
- **Data sources and data security.** With data playing a crucial role in the transformation of tax administrations, it may be helpful to produce a compendium and commentary on the different data sources used by countries both from internal and external sources, including other parts of government. A companion piece could cover aspects of data management, including the data security and data protection issues being grappled with by tax administrations and which are of critical importance in achieving the goals of future tax administration.
- **Facilitating joint audits.** A number of pilot projects have been undertaken on joint audits which are seen as an important development for enhancing tax certainty and helping to avoid the triggering of

resource-intensive and lengthy Mutual Agreement Procedures. It would be useful to further examine the main lessons to be drawn from the pilot initiatives and the potential solutions to issues identified, including as regards the legal base as well as ideas that could improve effectiveness (such as a template Code of Conduct).

Please note that the outlined forms of co-operation in this chapter and the respective recommendations should not be understood as an obligation on the part of tax administrations to introduce or partake in such co-operation. In this respect, tax administrations operate in line and within the boundaries of domestic legislation and international standards.

Chapter 1

The changing tax compliance environment

The purpose of tax administration is to collect revenue needed to fund public services and public goods in accordance with the law. This includes three core elements: optimising compliance in a cost-effective manner, reducing burdens and building and maintaining trust. These elements are impacted by all the activities done by a tax administration and therefore tax administrations should look at the mix of activities and how they can complement and support each other. The changes in the mix of activities are driven by changes in business models, developments in technology and the availability of data as well as changes in tax law.

This chapter describes the current mix of compliance activities ranging from reactive to proactive, "upstream" and "compliance by design", the changes that are occurring and what they mean for tax administrations and taxpayers.

1.1. The core elements of effective tax administration

The purpose of tax administration is to collect the revenue needed to fund public services and public goods in accordance with the law. There are three overarching elements to this, namely that tax administration should be done in a way which:

- optimises compliance in a cost-effective manner;
- minimises burdens on taxpayers; and
- builds and maintains the trust of taxpayers.

Getting this balance right can have significant impacts, both on the structural and sustainable collection of revenue and on the operation of the wider economy.

As reported in *Tax Administration 2017* (OECD, 2017), the 55 participating tax administrations together raise around EUR 8.5 trillion in taxes with on-time payments by taxpayers ranging between 84% and 95%. The overall combined budget of these tax administrations is around EUR 73 billion. A small change in compliance can significantly impact revenues. A 1% increase or decrease in revenues across countries would be greater than the overall cost of tax administration.

Equally the burden on taxpayers of complying with the requirements of tax law and tax administration can carry significant opportunity costs displacing productive economic activity or incurring large welfare costs. This is particularly a risk for small businesses which are the major employers in most countries (for example Szczepański, 2016 and Coolidge, 2010).

Trust in the fairness of the tax administration (and also the wider tax system) is also of high importance for the sustainability of the tax system and for maintaining and enhancing compliance. In this regard enforcement must be visible and credible, taxpayers seen to be treated fairly and with respect and that there are adequate service channels including for queries and appeals. In all tax administrations, there remains a heavy reliance on voluntary compliance by taxpayers to report the full set of information needed to establish taxes due and to file and pay on time. Where trust in the fairness of tax administration breaks down or taxpayers feel detached from the social norms supporting the payment of tax, they may become disengaged and more prone to underreport or less concerned about errors. At the extreme it may encourage some to take active steps to evade tax obligations.

None of the three elements outlined above – optimising compliance in a cost-effective manner, reducing burdens and building and maintaining trust – can be tackled in isolation. They form a single piece impacted by all of the activities done by a tax administration. It is important, therefore, to look

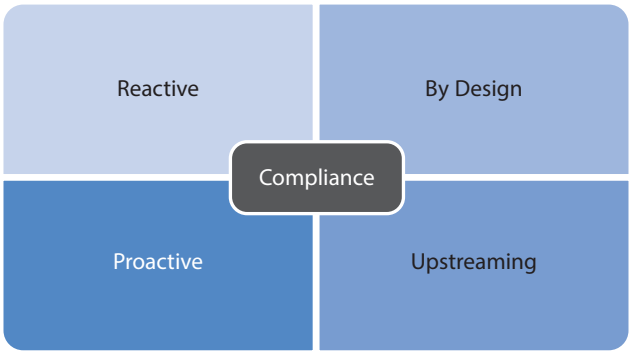
both at the mix of activities and how they can complement and support each other in achieving these goals. It is also important to be aware of situations where changes in the mix of activities may involve trade-offs, for example the impact on burdens and trust from changes in the use of audit or enforcement. In this regard administrations may wish to give particular attention to how they best communicate their overall approach and strategy internally and to the wider public.

1.2. Compliance related activities

One way of describing the set of activities undertaken by tax administrations to achieve these objectives is according to their timing. This division has been included in earlier publications of the Forum on Tax Administration (FTA) such as *Tax Compliance by Design* (OECD, 2014) and *Right from the Start* (OECD, 2012) and has proved a useful framework for thinking about compliance activities.

- **Reactive activities** which broadly divide into two main classes. First, activities responding to taxpayer inquiries which can range from queries as to their assessed tax liabilities to general questions about deadlines and obligations. The second main class is investigations and audits carried out after the filing of returns (which may relate to tax due or tax refunds). While reacting to events such as tax filings, audits are simultaneously both backward and forward looking.
- **Pro-active activities** which are performed prior to the taxable event or tax filing and which inform and influence future actions. Examples include explaining the implications of new tax laws or processes, providing information on tax obligations and deadlines and seeking to influence compliant behaviour. This can be, for example, through co-operative compliance programmes and behavioural nudges etc.
- **"Upstream"** activities and **"compliance by design"** which relate more closely to taxable events with the purpose of facilitating and ultimately managing compliance by the taxpayer, including in preventing errors and misapplication of the law or in managing tax debt. This can range from aligning recording (and possibly payment) of tax liabilities to the time a transaction or payment occurs, to tax rulings, the provision of specific guidance (whether in person or through other mediums) and early interventions when a potential tax debt issue is recognised. Increasingly these types of activities are occurring in real, or near real time.

Figure 1.1. **Framework for timing of compliance activities**



All administrations already undertake activities across this range and will continue to do so. These ways of managing the tax system (which involves the taxpayer and third parties as well as the tax administration) will always co-exist. What will change over time is the mix of activities. This will largely be driven by:

- **changes in economic activity**, in particular the increase in e-commerce and changes in patterns of employment and business activity, for example through the sharing and gig economy;
- **developments in technology**, the availability of data, the use of electronic payments and invoices and wider changes in taxpayers' daily environments. These will have significant impacts on taxpayers' expectations and behaviours, whether as consumers or businesses;
- **changes in tax law and structures** which may simplify or complicate tax law but where policy makers should also consider carefully how tax can be administered and collected most effectively.

Depending on their different stages of development, cultural and societal attitudes and legal systems (including as regards the use of data), tax administrations will currently employ a different mix of activities both compared to other administrations and even within their own administration.

In general terms, previous FTA publications have encouraged moving from reactive activities – the traditional post-filing checks which will often be one-to-one – to more pro-active one-to-many interventions, greater upstream assurance of tax closer to taxable events and ultimately compliance by design approaches.

The potential benefits of such a shift in the mix of activities can be:

- a reduction in errors and under-reporting of taxable income and improvements in the early detection of high risk areas, fraudulent activity or potential tax debt;
- a decrease in burdens on taxpayers, with more of the administration of tax embedded into the systems they use day-to-day, including the bringing together of data from different sources;
- an increase in the trust of taxpayers from greater understanding of their obligations – often from improved service, including simpler and less frequent interactions with tax administrations;
- greater tax certainty from the taxpayer's perspective, reducing potentially harmful impacts on cash-flow and allowing more informed investment, business and expenditure decisions;
- a reduction in expensive post-filing or post-payment investigations, with increased concentration of such activities on higher risk taxpayers or transactions.

1.3. New tools and technologies

The current reality for most tax administrations is that there is still a very large focus on reactive activities. Figure 1.2 shows approximately one-third of the staff of tax administrations participating in the report *Tax Administration 2017* (OECD, 2017) work directly on audit activities (excluding administrative support), with on average 14% engaged in answering queries from taxpayers.

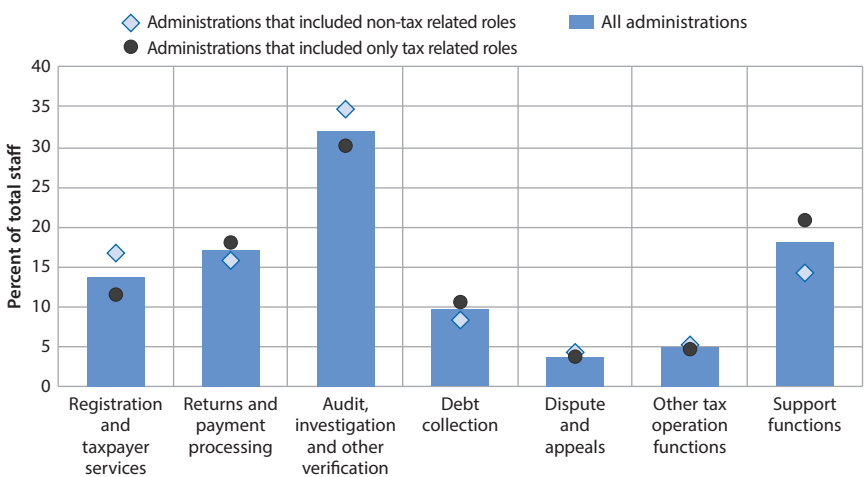
As a result of changes in economic activity, technology, availability of data and the wider tax "ecosystem", many tax administrations are now rethinking the balance of their activities. These changes are explored in detail in Chapter 3, but in summary recently there has been:

- a large increase in the number of third party developers and consequently in the range of available applications, for example the development of mobile apps or business software with embedded tax rules, calculators and payment channels;
- unprecedented increases in the availability, capability and portability of digital devices. In particular there is now a large scale penetration of powerful mobile devices in many countries. These are capable of undertaking sophisticated calculations and processes, of recording and transmitting data digitally and interlinking with other devices and systems, including payment systems. In addition, there is increasing use of trust building technology, such as systems supporting e-invoicing

and electronic cash registers. These can lead to a higher level of assurance and built in compliance, reducing errors and opportunities for underreporting;

- enhanced systems for authentication and identification, ranging from multi-step verification (for example password, date of birth, one-off codes etc.) to biometric information, including voice identification. The emergence of blockchain technology also carries the potential to provide for more secure verification of transactions, payments and identity;
- increased use of robotic applications for administrative tasks (for example retrieving and assembling information), business and machine rules (for example in assigning work or making rules-based decisions) and the emergence of artificial intelligence capable of making supervised judgements and learning by experience;
- greater sophistication and use of behavioural insights and advanced analytic techniques to uncover previously invisible patterns, surface new insights, make predictions and make recommendations; and
- an accompanying massive increase in the availability of digital data to tax administrations both internally generated and externally from third parties (for example financial institutions, other businesses or other government agencies) as well as unstructured data (for example email content, internet "scraping",[1] social media etc.).

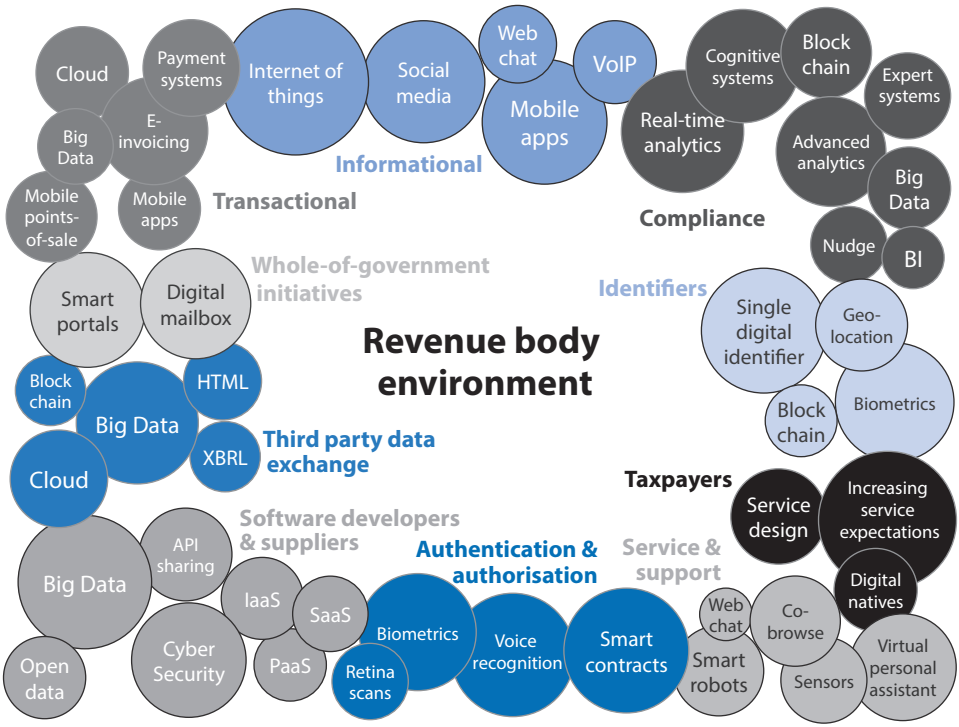
Figure 1.2. **Staff usage by function, 2015**



Source: OECD (2017), *Tax Administration 2017 – Comparative Information on OECD and Other Advanced and Emerging Economies.*

These and other disruptive technologies and tools are increasingly being examined and used by tax administrations both for improvements in the delivery of a number of existing services or processes but also for rethinking tax administration in a holistic manner.

Figure 1.3. **The revenue body environment**



Source: Australian Tax Office (2016).

1.4. The changing mix of compliance activity

1.4.1. Reactive activities

Reactive activities in many countries have already been undergoing changes for some time.

With regard to audit the general trend across tax administrations is that one-to-one traditional audits have become more risk based with increasing use of advanced analytics and rules-based systems to identify potential anomalies and higher risk activities or transactions.

Where tax audit was traditionally the cornerstone of any tax compliance strategy, current developments in tax administration and tax compliance seem to point towards "compliance by design" approaches. In such approaches the focus is much more on creating an environment in which paying taxes is as much as possible integrated into day-to-day financial and transaction processes.

These developments are being facilitated by:

- the increasing volume of available data as a result of e.g. more digital recording of transactions by business or third parties and an increasing volume of unstructured data;
- cross-border business transaction and data processing;
- new technologies assuring authenticity and integrity of data for example advanced analytics and rules-based systems;
- increasing machine to machine communication; and
- increasing desire for real-time assurance by taxpayers.

As a result tax audit in the traditional sense, i.e. checking of individual tax returns, will be less important in future tax administrations' compliance strategies, as interventions become more systemic and upstream. Audit will still be needed to help check the working of the system, e.g. checking whether system measures are correctly implemented. Tax audits will as much as possible leverage on work that is done by other parties, such as public accountants and tax service providers increasingly based on shared standards and norms. Audits may also add insights for setting priorities in compliance activities, for example through information gained via a random audit programme.

Innovation in tax audit methodologies and techniques is needed to allow for more real-time and online approaches and to make audit a more integrated part of modern compliance strategies. As work processes become more independent of time and place, data can be accessed "anytime, anywhere". In the future, tax audit may not be seen as a separate process anymore, but may fall into categories such as "monitoring and analysis", "system assessment" and "customer interaction".

1.4.2. Proactive activities

New technologies, tools and analytical capability are expanding the range of proactive activities undertaken to facilitate compliance, for example:

- **Identifying ways to make it easier to understand and report tax obligations**. This encompasses examining structured and unstructured

data to identify and reduce friction in processes such as form filling or areas of uncertainty, understanding where guidance and communications need to be made clearer and working with third parties on building tax compliance into the taxpayer's natural environment.

- **Examining which channels and which form of proactive interaction with the taxpayer are most effective**. Such interactions can be done by third parties as well as the tax administration. What works best in facilitating compliance will, of course, often be particular to a jurisdiction, but will often coincide with the channels, devices and formats that taxpayers are using in other aspects of their daily lives.
- **Changing the context in which the behaviour occurs**. There is strong evidence that if people believe they are observed or if information is known, then they are more likely to comply. The growing body of behavioural insights and nudge techniques have allowed many tax administrations to influence taxpayers in more targeted ways even in the absence of full data sets.

In all of these areas it is important both to work and consult with taxpayer groups and a range of third parties (whether advising taxpayers or providing an actual or potential service) on the design of such arrangements to ensure that they are user centric as well as efficient and effective.

1.4.3. Upstreaming and compliance by design

Developments in technology, information flows and the tools and services available to taxpayers and the tax administration are also making it possible to move elements of compliance upstream, including through embedding tax rules into software and the use of trusted and secure chains. Ultimately this should lead to an increase in the management of compliance by design as exists in many countries for salaried employees in pay-as-you-earn withholding systems (PAYE). The key difference in this perspective from reactive activities is that the services and solutions are offered by the tax administration in collaboration with other parties interacting with the taxpayer (such as employers, service providers, software and application developers and so on).

As a result of the increased availability of data, the use of compliance by design approaches are spreading to more complex situations, in which there are multiple sources of income and revenue. While there remains an element of voluntary compliance in such systems for income not picked up by the tax administration systems, this can be expected to shrink over time as more data sources become available or with the use of innovative compliance management techniques. As the extent of pre-population is determined by the range of electronic data sources available to the administration, in order for

this form of compliance by design to become more widespread it is critical that consideration is given as to whether the legislative framework should allow more extensive and timely sharing of data.

Of course there remains scope for fraud in compliance by design approaches, although in a closed or largely closed system (such as PAYE) this will be an increasingly small number of taxpayers who are prepared to cross a boundary into criminal activity. Compliance by design still, therefore, will rely on a checking of the systems (a form of audit) but this may not always be done by the tax administration but could be done by external auditors or other third parties.

Note

1. Programmes which allow large amounts of data to be extracted from websites, for example advertisements, business addresses and descriptions etc.

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Chapter 2

Tax compliance strategies

Tax compliance strategies have been evolving over the past two decades, shifting the focus from the individual taxpayer to a group of taxpayers and the broader compliance environment. Additionally, tax compliance strategies are developing towards a more systemic understanding of compliance risks. The on-going research to better understand what motivates tax compliance is allowing tax administrations to design and implement better systems and to develop more effective compliance strategies.

Expanded data sources, advanced analytics approaches and real-time interventions, trust-based technologies and the expansion of co-operative arrangements are driving factors in the so-called "journey upstream". Increasingly tax administrations are working with third party providers of data and service in new business arrangements requiring new capabilities. In this new tax ecosystem tax administrations should be able to manage commercial relationships and effectively empower third parties as well as also having systems and processes in place to monitor their performance.

Interventions are moving from post–event auditing to better systems design and earlier, upfront assistance and demand a more customer-focused approach to compliance to achieve greater efficiency and better outcomes.

This chapter provides an overview of the evolving compliance strategies and current priorities in managing compliance risk. Additionally, it describes a number of factors that are driving the changes in how tax administrations are seeking to manage compliance.

2.1. Introduction

For almost half-a-century tax administrations have utilised generic and leverage based approaches and systems to manage the tax obligations and requirements of taxpayers as well as their rights. Administrations have developed strategies and approaches to manage large populations of taxpayers in order to balance cost and effectiveness. Individual approaches are generally impracticable or impossible without a vast number of tax officials. These approaches, based around groups or segments rather than those of individual taxpayers, mean there has always been the risk of tax non-compliance. A risk which administrations have had to manage, seek to eliminate or accept.

The bedrock of tax administration has been voluntary compliance supported by well-designed systems and processes and appropriate enforcement activities that support a self-assessment system.[1] Tax systems rely heavily on complete and accurate reporting of information by taxpayers (self-assessment). Verification and audit activities are important to secure the system, influence wider behaviour, reinforce social norms, and to assess (and collect) the correct revenue due.

To achieve compliance outcomes, administrations have supported the voluntary compliance efforts of the taxpayer with elements of facilitated compliance – for example through access to in-person support, or self-service options or publications – and increasingly managed compliance – for example collection of individual employees' income tax in many countries under pay-as-you-earn systems.

The main elements of their compliance strategies which have matured over recent years have been better targeting of activity through enhanced risk management; a greater understanding of how to influence taxpayer behaviour; and more sophisticated understanding of enforcement activity. While the principles which underpin compliance risk management approaches still remain valid, the tax compliance paradigm is now undergoing a further shift.

This chapter examines the evolution of tax compliance strategies over the past two decades. It also discusses the role of new tax service providers and participants in the wider tax environment, and the vast increase in the availability of data, and what that means for the use and mix of voluntary, facilitated and managed compliance approaches. The impact of this shift on tax audit is explored in Chapter 3.

2.2. Compliance strategies since 2004 – improving targeting

Since the introduction of self-assessment regimes in the 1970s and 1980s, most modern administrations have focused their administrative and

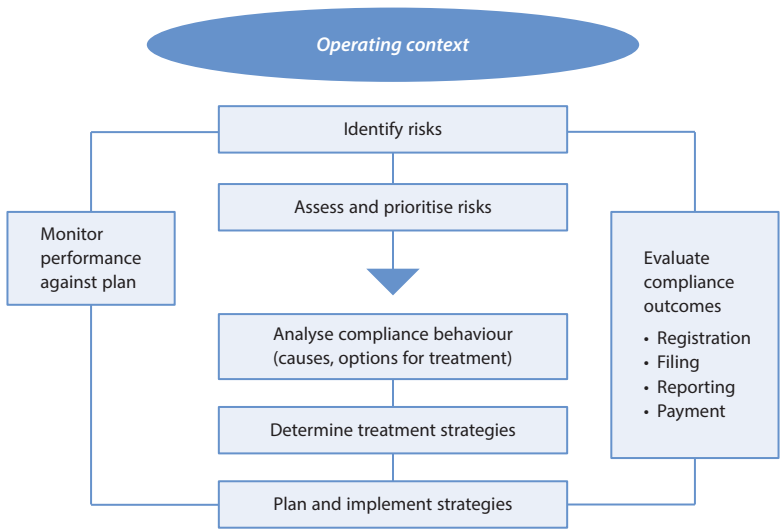
enforcement approaches on optimising levels of voluntary compliance by the taxpayer, while also seeking to minimise both their own administrative cost and the compliance costs for third parties.

While self-assessment approaches see most returns accepted and assessed as filed, administrations have developed new tools to help identify those returns that should be subject to post-assessment verification or audit. The advent of analytical software and tools allowed over-time for greater sophistication in risk assessment approaches and models. These became more granular, flexible and responsive to factors such as business or industry type, economic factors and behavioural aspects of taxpayers segments.

2.2.1. Pursuing a risk management approach

Compliance risk management was first explored in-depth in the Forum on Tax Administration (FTA) guidance note *Compliance Risk Management: Managing and Improving Tax Compliance* (OECD, 2004). Based on the experience of leading tax administrations, the note looked at how the use of modern risk management techniques could help tax administrations develop more effective risk-mitigation strategies. As set out in Figure 2.1, the framework showed compliance risk management as a cyclical process

Figure 2.1. **Compliance risk management process**



Source: OECD (2004), "Compliance Risk Management: Managing and Improving Tax Compliance" (guidance note), www.oecd.org/tax/forum-on-tax-administration/publications-and-products/compliance/33818656.pdf.

capable of enhancing the evidence base for risk identification and compliance activities over time.

The framework continues to serve as an effective process more than a decade later. It sets out the key steps in developing a more systemic understanding of compliance risks, shifting the focus from the individual taxpayer to the broader compliance environment. It allows administrations to prioritise and to consider where they should adapt their processes and develop new capabilities, including in the area of communication and education, and where they should place greater reliance on proactive and close to real-time approaches.

Subsequent FTA reports have explored aspects of this shift in perspective and provided tax administrations with practical guidance and examples of best practice:

- **Influencing compliance behaviours:** The FTA information note *Understanding and Influencing Taxpayers' Compliance Behaviour* (OECD, 2010) recognised the shortcomings of standard economic models in explaining compliance behaviour and set out five broad categories for influencing behaviour positively: opportunity, social norms, fairness considerations, economic incentives, and deterrence.
- **Shifting from reactive to proactive approaches:** The 2010 information note underscored a shift from reactive activities targeting symptoms to more proactive approaches aimed at the causes of non-compliance.
- **Right from the start thinking:** The 2012 information note *Right from the start: Influencing the Compliance Environment for Small and Medium Enterprises* (OECD, 2012a), looked at how administrative systems and processes might be reshaped to "build-in compliance".
- **Collaborative and user-oriented approaches:** The FTA report *Together for Better Outcomes: Engaging and Involving SME Taxpayers and Stakeholders* (OECD, 2013a) explored how administrations might involve taxpayers and other stakeholders in developing better targeted services and interventions to help influence SME compliance.
- **Leveraging new technologies and service providers:** The FTA report *Tax compliance by design* (OECD, 2014) described how tax administrations could exploit developments in technology and the ways in which modern small and medium enterprises (SMEs) could organise themselves to incorporate tax compliance into the systems used to manage their financial affairs. These approaches were further explored in the report *Rethinking Tax Services: The changing role of tax service providers in SME tax compliance* (OECD, 2016a).

While the compliance risk management model and its principles remain valid, what is changing are the:

- **approaches** used to identify, assess and prioritise risk, with many administrations now making use of new technologies and advanced analytics;
- **information sources** which are increasingly based on external data, particularly unstructured data, as well as information supplied by other countries;
- **timing of interventions**, more of which are now occurring in real-time or close to real-time;
- **type of treatment**, with simpler interventions increasingly becoming more automated; and
- **application of methods,** where new tools and models are allowing administrations to manage "complete" segments or micro-segments rather than using risk approaches to allocate scarce resources to best cases.

These changes are causing administrations to not only re-think their approach to managing tax compliance and compliance risk, but also the nature and timing of many of the traditional interventions they have used. It is also requiring them to ensure the tax legislation and regulations, particularly as these apply to how they obtain and use data, enable these issues to be addressed in a contemporary manner that reflect the expectations of policy makers and citizens.

2.3. Understanding and influencing taxpayer behaviour

Influencing taxpayer behaviour is not a new concept in tax administration. Most administrations have had programmes and activities in place for several decades to assist taxpayers to comply as well as to deter non-compliance. The extensive on-going research undertaken to better understand what motivates tax compliance is allowing administrations to design and implement better systems and to develop more effective compliance strategies.

The FTA information note *Understanding and Influencing Taxpayers Compliance Behaviour* (OECD, 2010) contains a review of literature on the topic. It also documents some of the extensive array of activities undertaken. The factors identified and the commentary remain of value. The report found that while there is no simple answer as to how best to influence taxpayer behaviour, administrations should adopt compliance approaches which combine:

- **Deterrence:** the risk of detection and/or severity of punishment are often the first response that comes to mind when the general public is asked about how a revenue body promotes compliance. Studies demonstrate, however, conflicting evidence as to whether deterrence strategies have the desired behavioural influence with some administrations reporting that deterrence activities (large audit adjustments and monetary penalties) have actually emboldened taxpayers to be more non-compliant in subsequent years. Of particular interest is the finding that deterrence is more effective where strong social norms exist. Research findings also suggest that communication plays a critical role in how a deterrence strategy is perceived by taxpayers. It is not sufficient to simply deliver a message that non-compliant taxpayers are being detected; the public must also be reassured that most taxpayers are honest, as this promotes a strong social norm to remain compliant.
- **Norms***:* both personal and social, are considered to be the most important drivers of compliance. The challenge here is that while most administrations now accept the need to engage in longer-term pieces of work that permanently influence taxpayer behaviour, many have had little practical experience in this regard, instead tending to focus on short-term, output-driven indicators of performance. It is also important for tax administrations to be alert to, and promptly address, public misconceptions or inaccuracies that may impact social norms and hence taxpayer behaviour.
- **Opportunities***:* While tax administrations and policy makers have sought to limit the opportunities for non-compliance they have expended much less effort on making it easier for taxpayers to comply. The last decade has seen many looking at how withholding regimes, expanded third party reporting, and improved design processes including pre-filled returns, embedded services and the use of Application Programme Interfaces (API) can act to reduce the opportunities for non-compliance.
- **Fairness:** Research suggests that fairness, as exhibited by the revenue body or government, can play a role in taxpayer behaviour. This includes perceived fairness in the use of tax revenues, procedures and sanctions.
- **Economic factors:** There remains a lack of research to link economic factors to taxpayer compliance behaviour. The general conclusion drawn in the report however is that factors that promote economic growth tend to promote tax compliance.

Approaches cannot be looked at in isolation. How the various drivers of compliance behaviour interact with each other is an important consideration. For example controlling approaches may cause taxpayers to feel distrusted. Where this occurs research indicates that they may adopt the same attitude towards the tax administration, and this may reduce compliance.

In exploring these issues and designing their compliance management approach a number of administrations have utilised the work of John and Valerie Braithwaite on responsive regulation.

This work and in particular, Figure 2.2, the tax compliance model, produced in the late 1990s and reproduced for the FTA information note *Reducing opportunities for tax non-compliance in the underground economy* (OECD, 2012b), allowed administrations to consider matching interventions with behaviour, at least at a class of taxpayer or case level. The underlying assumption is that for most people (the base of the pyramid) the easier it is to comply, the greater the willingness will be to do so. The model also introduced the idea that given the regulatory nature of the tax environment and the long-term and on-going relationship between the tax administration and the taxpayer, administrations needed to be more aware of how compliance interventions impacted on future compliance behaviour.

Figure 2.2. **Tax compliance model**



Source: OECD (2012), "Reducing opportunities for tax non-compliance in the underground economy" (information note), www.oecd.org/tax/forum-on-tax-administration/publications-and-products/49427993.pdf.

2.4. The link between enforcement and compliance

A helpful model to understand the role of enforcement in tax compliance is the so-called Slippery Slope Framework proposed by Kirchler, Hoelzl and Wahl (2008). This work supposes two routes to tax compliance. The first, *deterrence* involving the use of audit and fines; the second by *building trust relationships* with the taxpayer through delivery of support and service. While the work concluded that both approaches are necessary to support tax compliance, it did identify that trust in authorities and the power of authorities as well as their interaction is decisive for tax compliance. Thus it is not whether power should or should not be used, but rather how it is used that is important.

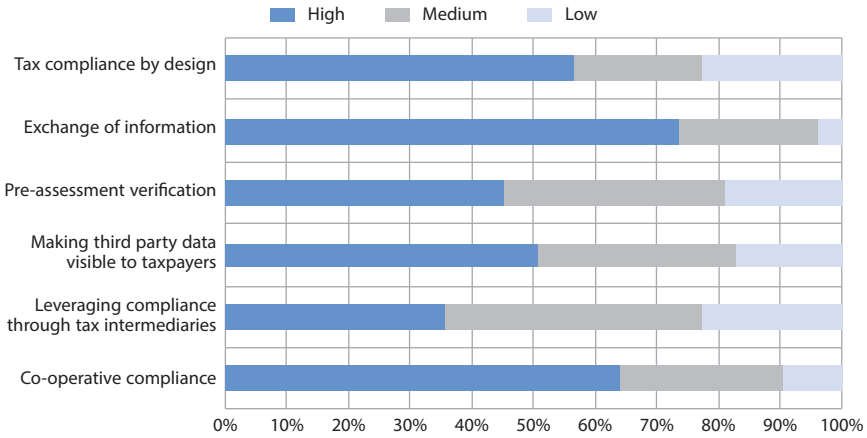
A deterrence approach, based on enforcement through audits and sanctions, can increase the perceived power of administrations and may result in enforced compliance, whereas a trust approach, based on co-operation and persuasion, can increase trust and may lead to voluntary compliance. If, though, the use of power by the revenue body is not perceived as legitimate but as coercive and unjust, enforcement will undermine compliance and especially voluntary compliance.

As a result, audit as a treatment to stimulate compliance at the case level does not always result in improved tax compliance. It is a more influential instrument at the level of the tax system. Thus utilising audits to detect and visibly address and remedy cases of tax evasion is essential not so much for the revenue they generated in individual cases, but to maintain or enhance trust in the tax system. Importantly this outcome will only be achieved when the actions of the tax administration are perceived as legitimate and just.

2.5. Current priorities in managing compliance risk

Most FTA tax administrations report having formal risk management procedures in place, with just over one-third of these making compliance risks public (OECD, 2017). There is a high degree of commonality among administrations on the relative priority attached to compliance interventions with Figure 2.3 illustrating the importance of using exchanged information and co-operative compliance arrangements. In respect of risk criteria tax administrations identified the following priority items within their current strategies: value added tax (VAT) fraud; aggressive tax avoidance schemes (including those leading to base erosion and profit shifting); the shadow economy; and transactions involving zero or near zero tax countries. Many administrations also identified e-commerce, identity-fraud, and high net wealth individuals (HNWIs) as medium to high priorities.

Figure 2.3. **Priority of compliance interventions, 2015**



Source: OECD (2017), *Tax Administration 2017 – Comparative Information on OECD and Other Advanced and Emerging Economies*.

While the compliance strategies described above remain valid and are important for understanding the compliance environment, new developments, such as described in paragraph 1.2, are allowing tax administrations to enhance wider taxpayer compliance while still maintaining targeted interventions where appropriate. Together these developments allow for more facilitated and more managed compliance. This will give tax administrations more confidence that the right amount of tax is being paid without any increase in the number of tax officials to manage taxpayer interventions, for example through audit. Further it will reduce the burden that tax administrations place on taxpayers.

These developments are driven by a number of factors:

- Expanded data sources;
- Advanced analytics approaches and real-time intervention;
- Automated interventions and trust-based technologies;
- Upstreaming and embedding compliance; and
- Expansion of co-operative arrangements.

These are discussed below. What they mean for the role that tax audit plays today and needs to perform tomorrow will be examined in in the following chapters on Tax Audit and International co-operation.

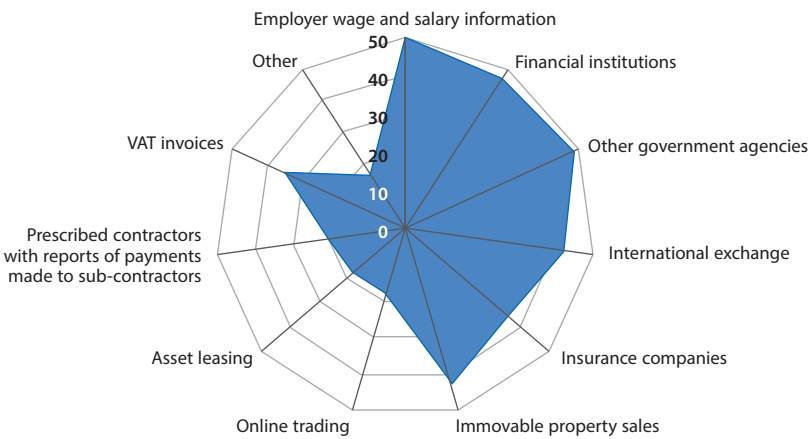
2.5.1. Expanded data sources

Tax administrations have always been data rich organisations. Many now report developing new data models to support traditional, largely structured data, as well as new unstructured data sets. This is allowing them to redesign systems and approaches to ensure that more data sources are available for managing customer interactions and support tax compliance.

Lower storage costs coupled with advances in analytics technologies have allowed administrations to not only source more data in support of new approaches and products, but to also facilitate better management of tax risks. This includes how they look to "upstream compliance". This phrase reflects the desire for compliance with tax obligations to occur as close to the transaction or tax event as possible, or to allow compliance where it naturally occurs for the taxpayer. New data approaches are also allowing administrations to differentiate service and interventions based on the perceived tax risk of a transaction, taxpayer or event, but they need to be embedded in a strategic framework to determine why data is needed and how should it be used.

Figure 2.4 illustrates that the bulk of third party data used by administrations is still sourced from organisations that have withheld income tax from individuals. As a result many administrations have been active in establishing processes to improve outcomes and simplify compliance for salary and wage earners. Some administrations are now able to pre-fill 100% of the data for selected groups of taxpayers. The practice is most widespread and successful in

Figure 2.4. **Use of third party data, 2015**



Source: OECD (2017), *Tax Administration 2017 – Comparative Information on OECD and Other Advanced and Emerging Economies*.

the Nordic tax administrations where it has led to impressive compliance rates and low administrative costs for personal income tax, which in these countries represent a very significant share of the tax base.

Increasingly the spread of digital payments, electronic invoicing and connected devices (like online cash-registers and point-of-sale solutions) is generating data that can be used by tax administrations. Taken together data on sales and on payments complement each other to form a picture of potentially taxable transactions. The great majority of tax administrations report they are expanding their collection of data, including third-parties from online trading, asset leasing, payments to subcontractors, and VAT invoices. How tax administrations position themselves to influence and leverage this environment and the data it produces will be a key transformative theme in managing tax compliance over the next decade.

2.5.2. Advanced analytics approaches and real-time intervention

Advanced analytics is the process of applying statistical and machine-learning techniques to uncover insights from data. The aim is to better inform decisions about the deployment of resources and the design of interventions and policies. Most advanced analytics projects use either predictive or prescriptive analytics approaches.

By developing a more systemic understanding of compliance risks, including better understanding the broader compliance environment and the causes of non-compliance, administrations are better able to adapt their processes and redesign systems. Further it allows them to determine where risks are best managed and whether they need new capabilities to effectively manage compliance risk. This approach is opening up a range of new risk mitigation strategies, including greater reliance on proactive and close to real-time approaches, collaborative approaches as well as tax policy and internal process change.

Of particular "downstream interest" is the extensive use by administrations of automated risk profiling as part of the return and payment processing operations, increasingly occurring in real-time or near real-time. This approach is allowing administrations to change the nature and timing of "compliance actions" undertaken to determine whether taxpayers have properly reported their tax liability. These sophisticated analytical models mean administrations are better able to identify returns, claims or transactions which might require further review.

The timely and efficient provision of service is a critical part of tax systems based on voluntary compliance. The taxpayer service function

proactively and reactively provides information and services to taxpayers. This includes responding to inquiries on the application of tax laws as well as statutory determinations on the administration's view of the law. Such real-time interventions provide benefits to taxpayers getting tax issues right from the start and providing greater tax certainty about obligations. Promoting positive compliance also means being able to identify and act in real-time to prevent errors and support taxpayers in a transparent and open manner.

Box 2.1. **VAT real time risk model**

In ***Ireland*** the Revenue authorities have expanded their risk management scope by incorporating real time risk analysis in their compliance and collection programmes. The new VAT real time risk approach, which was introduced to assess VAT risk and identify suspicious VAT returns by making better use of internal available data, is an example of a rules based approach that is improving prevention and detection of non-compliance. The VAT rules applied include primary controls as well as taxpayer specific data such as return and payment history, company status, and return and payment compliance for other taxes. Once the rules are applied, a risk score is produced, which is used to categorise cases as either green (low risk) with any VAT refund due being paid; orange (medium risk); or red (high risk) with intervention required by a staff member and any refund claimed being held until fully investigated. The success of this risk based approach highlights the importance of data analysis and risk management. In 2015, in excess of 58 000 red risk VAT cases were examined resulting in an indirect yield of EUR 168 million.

Source: Ireland – Office of the Irish Revenue Commissioners (2017).

Consistent with taxpayers' right to be informed and assisted, it is now common practice for administrations to provide taxpayers with information on how they will interpret the laws they administer. Rulings are an important area where administrations can not only provide effective service but also assist in improving the certainty of the tax system by advising taxpayers how it will interpret the tax law in particular situations. Rulings are either *public* – a published statement of how an administration will interpret provisions of the tax law in particular situations; or *private* – relating to a specific request from a taxpayer for greater certainty as to how the law would be applied by the tax administration in relation to a proposed or completed transaction(s). By engaging taxpayers, their representatives and other stakeholders such as industry associations, improved outcomes for both the taxpayer and the tax administration can be achieved. The knowledge gained can also be applied to tailor products and interventions, to design processes and solutions that are more meaningful, and to improve the overall effectiveness of the tax system.

2.5.3. Automated interventions and compliance and trust enhancing technologies

Automated interventions refer to the design and integration of "processes or methods into systems, whether mechanical or software, that operate with varying degrees of autonomy and intelligence, and that reduce the need for human intervention to a minimum. Such interventions are referred to as Robotics or Robotic Process Automation (RPA).

Compliance and trust enhancing technologies are those technologies or properties of technology that support and improve the confidence taxpayers have while transacting electronically. In the tax ecosystem compliance and trust enhancing technologies include technologies such as digital cash registers and devices that track sales, production or consumption at different stages of the value chain.

Two fundamental shifts in the tax environment that are set to strongly influence the management of tax compliance are the emergence of a growing number of automated interventions and the expansion of what are termed trust-enhancing technologies:

- **Automated interventions** – a growing number of tax administrations report the use of "automated machine actions" using rules-based approaches to treat defined risks (e.g. automatically denying a claim, issuing a letter or matching a transaction).

  These "robotic" activities many of which are occurring in near real-time, are replacing some audit actions or steps previously performed by people. They are allowing administrations to monitor and review populations of data, and in many instances to undertake basic verification or matching action more effectively and efficiently than traditional "desk based verification review".

  These new interventions are also changing the way many administrations think about coverage, adjustment rates and yield. For those using automated interventions informed by advanced analytics, adjustment ratios across the population fall as coverage rates reach close to 100% of particular returns, transactions or risk. However, where it replaces activity previously undertaken manually there is a substantial reduction in cost per audit.

- **Compliance and trust enhancing technologies** – these include technologies such as digital cash registers and devices that track sales, production or consumption at different stages of the value chain. An established method to combat suppression of cash sales is the requirement to use electronic cash registers. Such registers transmit sales information directly to the tax administration or record the

information on a secure device that can only be accessed by the tax administration. Since the 1990s, several countries have implemented mandatory electronic cash registers for retail businesses, many achieving considerable revenue increases as a result.

In a growing number of countries, technological solutions have helped launch *electronic invoicing systems.* These enable tax administrations to access invoices directly to help alleviate the risks from taxpayers using false invoices for VAT and income tax. It is important to note that the technological innovations to combat sales suppression and false invoicing can also have positive effects for taxpayers. As well as increasing tax certainty, it can lead to a reduction in compliance costs and significantly reduce the likelihood of audit as well as supporting fair competition. The Swedish electronic invoicing system includes a simplified accounting system for businesses, which provides the taxpayer with monthly financial statements and generates prefilled annual returns. In Italy, businesses that use electronic invoices can benefit from quicker VAT refund processing.

Box 2.2. **Use of certified cash registers**

In ***Russia***, the Federal Tax Service (FTS) has started the transition to mandatory use of online cash registers which will be complete by July 2018. The system allows retailers to instantly upload transaction data to the FTS in real time mode. As required by legislation, each receipt generated by online cash registers contains a scannable QR code. Customers can use a dedicated app to verify their transaction by comparing the data in the receipt to the information uploaded to the FTS.

Source: Source: Russia – Federal Tax Service; Italy – Revenue Agency (2017).

The likelihood is that these changes will only deepen and accelerate in coming years as the use of both automated interventions and trust-enhancing technologies mature and regulators look to enable their use.

2.5.4. Upstreaming and embedding compliance

Upstreaming compliance reflects the desire by administrations for compliance with tax obligations to occur as close to the transaction or tax event as possible, or to allow compliance where it naturally occurs for the taxpayer. To achieve this, tax obligations, for example filing, may be "embedded" into other systems, for example payroll or banking applications that taxpayers use in other parts of their lives.

Technology is enabling new types of services some of which are allowing tax obligations such as filing to be met automatically or as a "by-product" of using another system or service. These new approaches offer tax administrations a range of new opportunities to leverage "smart devices" and data sources. It provides the opportunity to significantly change business processes and what taxpayers are required to do to meet their tax obligations. The 2016 OECD report *Technologies for Better Tax Administration* (OECD, 2016b), explored how technology could help administrations better address tax compliance and service delivery, primarily through the use of big data, smart portal solutions and natural systems. The report stressed that alongside investment in technology, administrations needed to improve their understanding of customers and the wider ecosystem in which they operate. The report encouraged administrations to be more responsive in delivering contemporary services and to identify opportunities to either embed tax requirements into third party systems or to use data and analytics to "move compliance upstream."

This opportunity to integrate data and/or tax requirements into third-party systems used by taxpayers has the potential to make tax requirements close to invisible for many. Embedding compliance, including upfront verification, in the design of tax administration systems should substantially reduce administrative burdens, freeing up taxpayer and tax administration resource, while improving overall compliance. These benefits, including a better taxpayer experience and greater taxpayer confidence in the integrity of the tax system, can also be realised to a greater or lesser extent in different taxpayer segments during the transition to full integration of tax-relevant data (including on identity). For example, in a growing number of countries interactions with the tax system for salary and wage earners is already minimal, with tax deducted at source, and only limited or no end of year "square-up process" or formal reporting.

Greater use of third party data can also already improve post-assessment actions, enhance risk assessment and, with advanced analytics, inform wider tax strategies. Even the simple capability to access third party data, as a number of studies have shown,[2] can also have a strong positive impact on compliance. Nevertheless, tax administration should be aware that third party data may not always present the full and correct picture, in particular in cases of collusion, which could mean that there is still non-compliance or evasion.

The use of pro-active messaging, calling, and other interventions in anticipation of potential non-compliance has paved the way for administrations to look more closely at how advanced analytics can improve service delivery for taxpayers. Such uses are set to become of greater importance to tax administrations in the coming years as compliance and verification moves upstream, and more of these processes occur in real-time or close to real-time.

A growing number of tax administrations report they are now developing options for pushing information, services and business rules out into the ecosystem. This can involve integrating tax information, guidance and other functionality in the bookkeeping software. Such integration can enable any issues to be identified prior to or during the filing process potentially reducing the need for post filing audits (see OECD, 2016b). Examples of such approaches are set out in Box 2.3 where the approaches taken by the United Kingdom, New Zealand and Denmark in collaborating with software developers are described.

Box 2.3. **Collaboration with software developers to integrate tax into taxpayers' natural systems**

In the ***United Kingdom,*** Her Majesty's Revenue and Customs (HMRC) is investing GBP 1.3 billion into a programme to make tax administration easier, quicker and simpler. This programme is already well underway. Transforming HMRC into a digital tax administration is allowing it to reduce the burden of tax compliance for taxpayers. Small businesses and individuals can now use digital tax accounts for a growing range of tax transactions, giving a personalised and increasingly real-time user experience. The ambition is to show exactly what is owed and to make the tax system easier to comply with. Ultimately digital tax accounts will replace annual tax returns in their current format. A key strand of HMRC's strategy is the requirement for most businesses to maintain their records digitally and to update HMRC quarterly. This will improve the levels of voluntary compliance, reduce amounts lost through error, and provide the environment for business to grow and thrive. The overall digital strategy is supported by published APIs to enable taxpayers, their agents and commercial software to transact with HMRC, encouraging the development of third party products.

In ***New Zealand***, Inland Revenue concluded a successful pilot project in 2015 that allowed businesses to submit Goods and Service Tax (GST) returns through the accounting software of two providers that cover 75% of the SME accounting services market. In a survey of 422 pilot participants, 64% said the new service reduced their costs and 76% said it made it easier for them to ensure they were submitting correct information. Many suggestions also came forward in the trial (including from Inland Revenue) as to how to fix mistakes in tax returns online and to set up online payment plans to clear debt. The software providers released the GST filing service to all clients in mid-2016. Inland Revenue is now looking at digital options for Pay-as-your-earn and social payments.

Box 2.3. **Collaboration with software developers to integrate tax into taxpayers' natural systems** *(continued)*

In ***Denmark,*** the Danish Tax Administration (SKAT) is collaborating with software developers to embed tax-related guidance and functionality in third-party accounting software solutions targeting small business. The long-term ambition is that transaction data flowing from banks to accounting systems should form the basis for a semi-automated process that integrates with SKAT's business processes. The first product of the collaboration is a comprehensive yet user-friendly bookkeeping guide, which later in 2017 will be made available for integration in third-party accounting software in the form of an API. Functionality for reporting and paying value added tax, which is the main obligation of most small businesses, is the next phase of the collaboration.

Source: United Kingdom – HM Revenue and Customs; New Zealand – Inland Revenue; Denmark – Danish Tax Administration (2017).

2.5.5. Expansion of co-operative arrangements

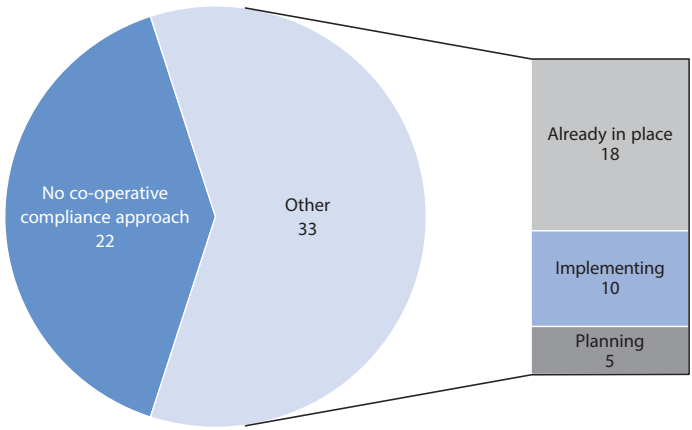
While co-operative compliance programmes differ between countries, they have in common the desire to establish a transparent relationship and more proactive approaches to resolving material tax risks between the tax administration and the taxpayer. Among the common requirements are the effective management of their tax affairs by taxpayers, the presence of a formal tax control framework and the absence of pending issues or arrears when entering the programme. Most programmes are based on formal agreements.

An increasing trend in the administration of large business compliance is the use of co-operative compliance programmes. These programmes involve a more transparent relationship and more proactive approaches to resolving material tax risks. The concept of co-operative compliance has been the subject of several FTA reports, most recently *Co-operative Tax Compliance: Building Better Tax Control Frameworks* (OECD, 2016c).

The 2017 Tax Administration report (OECD, 2017) states that 60% of the 55 countries participating in that publication already have or are in the process of implementing a co-operative compliance programme for large business. Most often these programmes are based on formal agreements with specific companies, although in some countries these programmes are more informal. In a limited number of cases, the operation of a co-operative compliance

programme is based on legal provisions. Among the requirements for entering such arrangements, tax administrations most frequently cite commitment of the taxpayer to effective management of their tax affairs, followed by the presence of a formal tax control framework and the absence of pending issues or arrears.

Figure 2.5. **Co-operative compliance approaches – Existence and implementation status, 2015**



Source: OECD (2017), *Tax Administration 2017 – Comparative Information on OECD and Other Advanced and Emerging Economies.*

As co-operative compliance approaches are built on the mutual interests and established processes of taxpayers, they are able to readily respond to changes in legislation or regulation. This has seen them already being adapted to accommodate the requirements of initiatives like country-by-country reporting and other outcomes from the OECD/G20 Base Erosion and Profit Shifting (BEPS) project into the tax control framework of the taxpayer and into the risk assessment systems of tax administrations.

The 2013 report *Co-operative Compliance: A Framework* (OECD, 2013b) recommended the development of multilateral co-operative compliance programmes. The changing international landscape, including as a result of the outcomes of the BEPS project, is leading to a stronger interest within tax administrations as to how they can co-operatively assess multinational enterprises and the opportunities for joint or simultaneous audit. This is partly with an eye to reducing the number of disputes coming into Mutual Agreement Procedures (MAP).

Some tax administrations report considering the extension of co-operative compliance approaches, successfully used in the large business areas, into other tax segments. This expansion is largely based on improvements in

compliance risk management made possible by access to a wider range of data, advanced analytics and risk assessment techniques. More active engagement with industry associations, taxpayers and other government agencies is also providing administrations with more insight into how to improve services and enhance compliance, including through possible changes to tax policy.

Box 2.4. **Liaison Officer Initiative (LOI) – Canada Revenue Agency**

In ***Canada*** the Canada Revenue Agency introduced an SME-specific instrument: the Liaison Officer Initiative, to provide support and training at key stages in the life cycle of these businesses. With the Liaison Officer Initiative (LOI), the CRA is shifting its compliance approach to offer proactive support. LOI activities are geared toward providing timely education and building a stronger relationship between taxpayers and the CRA. The LOI provides in-person guidance, support and information that will help taxpayers understand and navigate the tax system. Early support and certainty make it easier for taxpayers to meet their tax obligations. By identifying emerging issues and answering questions for a business in the early stages of development, the CRA can help prevent more serious problems that would cost more to resolve later. The LOI provides the following free and voluntary services to taxpayers:

1. Small business support visits to their place of business to give support and guidance on tax matters.
2. Books and records review with feedback and guidance on their accuracy and completeness.

After completing a successful pilot project, the LOI was deployed nationally in fiscal 2015. Currently, the LOI is offered to new small businesses (sole proprietorships/partnerships) selected by the CRA and the programme is expanding to include other business lines and a "visit by request" service. A total of approximately 160 employees in field offices and 5 employees at the Headquarters administer the LOI.

Box 2.5. **Multinational Enterprises Compliance Focus – Inland Revenue New Zealand**

The multinational enterprises compliance focus is an intelligence-led approach on the Significant Enterprises customer segment which comprises nearly 600 taxpayer groups with turnover in excess of USD 80 million. 50% of such enterprises are foreign-owned, with a further 25% involved in international operations mainly through controlled foreign companies.

Box 2.5. **Multinational Enterprises Compliance Focus – Inland Revenue New Zealand** *(continued)*

This approach was introduced in 2012 and requires all significant enterprises to submit annually a basic compliance package (BCP) comprising a group structure, financial statements and tax reconciliations which are then examined closely. The risk rating from the review of the BCP, past history and other intelligence, determines the compliance interventions which can range from no action through to further review or an in-depth audit where required.

Based on the amount they pay, the top 50 taxpayer groups within the Significant Enterprises segment receive additional coverage, being account managed on a one-to-one basis.

This approach has proven to be very successful in securing. a large part of the corporate tax base through a wider range of more tailored interventions rather than relying mainly on the traditional audit product.

In 2015 the International Questionnaire was introduced to improve the understanding of major international risks. In 2016 the questionnaire was issued to over 300 foreign-owned groups with a 100% response rate.

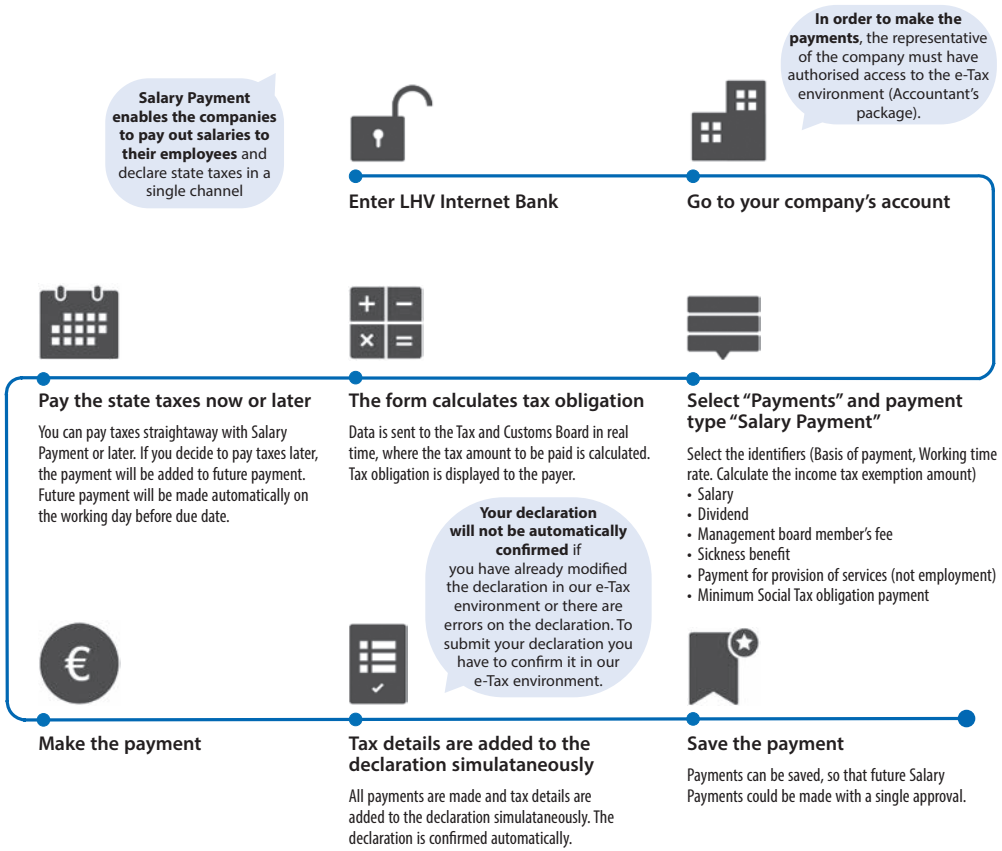
2.6. The journey upstream

Systems evolve and adapt over time. The current tax ecosystem is a product of prior actions and initiatives and the use of existing and emerging technology. In considering where the current thinking in tax compliance might take tax administrations, it is perhaps useful to look briefly at how one system, the pay-as-you-earn (PAYE) system, has evolved since its introduction in the 1950s and whether these changes may foreshadow what might happen in other segments or areas. While the overall tax concept of the PAYE system has not changed since its introduction, how it operates has changed significantly.

Payroll systems now handle greater sophistication in calculating taxes due. Employer periodic payments to tax administrations are now made electronically and in some cases as a natural part of completion of employee payroll activity.

When it comes to the end of year square up process, some administrations have removed the need for employees to file returns or declarations, essentially pre-filling the taxpayer account or return with payroll information. Increasingly this is being complemented with other withholding income (and tax) information, including interest and dividend income, and other data sourced from third parties. In their most advanced form, complete pre-filled returns are being generated for large proportions of the individual tax base of a growing number of countries.

Figure 2.6. **Salary payment solution for SME – Estonian Tax and Customs Board**



Source: Financial Service in Tallinn, Estonia (2017).

Box 2.6. **Salary payment solution for SME – Estonian Tax and Customs Board**

In April 2017 the Estonian Tax and Customs Board (ETCB) in co-operation with one of the commercial banks set up an innovative salary payment solution for SME that enables the companies to pay out salaries to their employees and declare state taxes in internet bank as a single channel. In the first three months, automatically received declarations went up from 23 in April to 98 in May and to 145 in June.

Box 2.6. **Salary payment solution for SME – Estonian Tax and Customs Board** *(continued)*

The company makes a salary payment in the company's bank account (currently the most common payment type). Data is sent to the ETCB in real time, where the tax amount to be paid is calculated and the tax obligation is displayed to the company. Once payments are made tax details are added to the tax declaration simultaneously and the declaration is confirmed automatically.

Source: Financial Service in Tallinn, Estonia (2017).

Box 2.7. **Pre-filled returns and compliance**

In ***Australia***, the Australian Tax Office (ATO) provides the opportunity for clients to choose to pre-fill information directly into individual income tax returns, including salary, interest and private health insurance data sourced directly from employers, banks and insurers. The information provided through this system helps the ATO improve services and makes it easier for those that want to comply to do so and harder for those that choose not to. In the last financial year, the ATO made close to 96 million transactions available for pre-filling, with taxpayers downloading more than 54 million of those transactions. It used over 636 million transactions reported by third parties to match individual income tax returns and other income statements. The ATO is using increasingly sophisticated data analytics and risk modelling to identify and review income tax returns that may omit information or contain incorrect statements.

The ATO conducted around 450 000 reviews and audits resulting in revenue adjustments of over AUD 1.1 billion in income tax. Cases involved omitted income or over-claimed entitlements such as deductions or offsets, including those significantly different to claims made by taxpayers in similar circumstances.

Source : Australia – Australian Tax Office (2017).

Thus the journey upstream which began in the 1960s and 1970s with moves to risk or exception based post-assessment matching, now sees nine FTA members (Estonia, Finland, Iceland, Lithuania, Norway, Peru, Portugal, South Africa and Sweden) reporting they can generate complete pre-filled returns for close to 100% of personal income taxpayers they expect to "file a return". Some have further extended the regime to introduce "deemed acceptance" of the prepared return after the expiry of a notice period.

The development of the pre-filled tax return has seen it shift from an approach which was considered only appropriate where the individual tax regime allowed relatively few deductions and credits, and where these could be verified with third party data sources. Advances in rules based technologies and analytics and the adoption of "problem-solving approaches" now mean the approach has more widespread use and adoption. Many administrations report strategies to extend the range of data sources used to improve coverage of the individual regime and the quality of the pre-filled return. Some tax administrations report exploring how the approach could be used in the SME and VAT segments.

2.6.1. New capabilities

As the role of tax administrations becomes increasingly about working with third party providers of data and services in new business arrangements that extend the traditional view of the tax ecosystem, it is important administrations critically examine the new capabilities they require. Overseeing the wider tax ecosystem requires tax administrations to be able to manage commercial relationships, ensure they can effectively empower third parties in agency situations as well as having systems and processes in place that monitor the performance of third parties as well as taxpayers.

As more of interventions move from post-event auditing to better systems design and earlier, upfront assistance, tax administrations will need to develop new skills as well as enhance and grow many existing capabilities. Traditional "compliance capabilities" will still be required but need to support broader, more customer-focused approaches to compliance to achieve greater efficiency and better outcomes. They also need to support effective decision making at appropriate levels, something which may challenge many current delegation and accountability models.

This has prompted the New Zealand Inland Revenue to identify the following more generic skills and knowledge as additional requirements in this area: the use of intelligence; digital and technology skills; knowledge of customer lifecycles; analytical and advisory skills; understanding and influencing customer behaviour; commercial and business acumen; and identifying, managing and mitigating risk.

When placed alongside other changes occurring in tax administration this points to the usefulness of a comprehensive, medium term resource and change strategy.

Box 2.8. **Staff capabilities**

Improving the capabilities of current staff and maintaining existing knowledge

Revenue bodies are complex organisation that can only function well when a broad range of expertise is available such as legal, tax and accounting expertise. In a changing revenue body, in which technological application and solutions are gaining importance, legal, tax and accounting staff as well as staff with other expertise should have basic IT knowledge.

Current working methods, techniques and solutions continue to be relevant and should get appropriate attention as well. Staff still needed to identify "old" risks and to tackle fraud that occurred years ago. Human intelligence can make an important difference in these cases.

Improving the capabilities of auditors

The survey responses indicated that tax auditors should also gain the following expertise and/ or (increased) knowledge on:

1. IT-audit skills, including data analytics, statistical techniques, big data and technical knowhow.
2. international laws and transfer pricing rules, including language skills.
3. soft skills for improving co-operation, communication and problem solving
4. improved risk assessment tools and techniques, including forensic techniques

It is therefore is important to develop appropriate staff training programmes. However, in practice is seems hardly possible to find enough auditors who have or are able to develop all the above mentioned skills. As a result a revenue body should look for alternative solutions, for example by using supportive tooling to help auditors in undertaking analysis, performing specific tasks automatically or assembling audit teams that include staff with different expertise.

Investment in IT experts

New strategies are building on the opportunities IT and technological innovations are creating. These strategies can only be implemented and operated successfully with qualified staff, in particular those with IT or advanced analytical skills.

Box 2.9 shows how the ATO is more actively designing in compliance by taking a more systemic approach. This is an approach they continue to refine and adapt – for example the development and use of an analytical model that risk assesses taxpayer claims in real-time is allowing the ATO to better manage work-related expense claims.

Box 2.9. **ATO Nearest Neighbour Model**

The Nearest Neighbour model enables the ATO to compare a taxpayer's work-related deduction claims against those in similar jobs and earning similar amounts of income to determine how far they differ from the norm. The use of the model that commenced as a pilot programme in 2014, issued letters to 2 000 taxpayers whose work-related expenses were higher than their peer group. The following year the ATO observed a significant reduction in claims from this group compared to their previous tax returns, especially for those where an amendment was made. Since the successful completion of the pilot project, the Nearest Neighbour model has been used extensively by the ATO to select higher-risk candidates for treatment. Currently, adjustment rates for those "potential risk" tax returns selected for audit using this methodology exceed 80%.

In 2016, the ATO extended the use of Nearest Neighbour to operate in real-time. If work-related expense claims seem higher than expected, taxpayers are prompted to check their claims before submitting their returns. The ATO will introduce similar online analytics for tax agent clients prompting them if a client falls outside "normal" claim parameters and may require their further attention. The ATO report that the Nearest Neighbour analysis is transforming the way they manage compliance, enabling a greater emphasis on prevention and self-correction to encourage willing taxpayer participation in the tax system.

With such managed approaches, where taxpayers are either not required to undertake actions or where more of their compliance obligations are met automatically, individual attitudes and behaviours will be of lesser focus than the overall operation of the wider tax system. When this occurs the traditional tax compliance model may well need to be redrawn.

Notes

1. "Self-assessment" refers to the manner of declaration and acceptance of such declaration rather than the distinction between self and official assessment.
2. See for example Kleven et al. (2010). The study finds evasion rate to be very small for income subject to third-party reporting, but substantial for self-reported income. It analysed a randomised experiment in Denmark with a sample of over 40 000 individual tax filers.

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Chapter 3

Tax audits in a changing environment

An audit provides more than just an examination as to whether taxpayers have correctly assessed and reported their tax liability and fulfilled other obligations. Audit plays a wider role in supporting tax compliance, deterring non-compliance and enhancing, the trust of taxpayers in the fairness and effectiveness of the tax system. This helps to reinforce social norms and to identify generic issues of potential concern to the functioning of the tax system.

In the current changing environment tax administrations are looking at how they can adapt their business models, service offerings and design approaches. Key to the success of these approaches is harnessing auditors' experience and knowledge. This will have implications for the role of tax audit.

This chapter looks at tax audit in a changing environment and identifies some areas where audit and the role of auditors might develop further as well as changes already underway.

3.1. The role of tax audit

The OECD report "Strengthening Tax Audit capabilities: General Principles and Approaches" (OECD, 2006),[1] defines tax audit as an examination of whether a taxpayer has correctly assessed and reported their tax liability and fulfilled other obligations. What are usually thought of as audits, are split into three broad categories, although the intensity and scope of such audits varies widely within those categories:

- **Comprehensive audits:** These are in-depth examinations of all the information and actions relevant to the calculation of a taxpayer's tax liability for a given period. Such audits can cover multiple taxes, issues and tax years and will usually take place on the taxpayer's premises. For large companies this will require considerable tax administration resources and will always be a significant burden on the taxpayer, particularly in the case of smaller businesses. The cost of comprehensive one-to-one audits means that they can only cover a small number of taxpayers. Increasingly comprehensive audits have been focussed on higher risk taxpayers identified by risk assessment processes.
- **Limited scope audits:** These are targeted at specific issues, taxes or tax years which are identified as potential risk areas of non-compliance specific to the taxpayer or the industry. Some such audits can cover just a single issue of concern. These are less expensive than comprehensive audits and can be effective across a wider number of taxpayers, including through influencing behaviour or increasing taxpayers' understanding.
- **Desk audit or review:** These are limited-scope examination of returns filed by taxpayers that take place within the tax administration rather than on the taxpayer's or their agent's premises. While they may involve the examination of documents and records, they frequently involve communication with the taxpayer via letter or phone to obtain explanations or information on issues of potential risk. This category of audit tends to make up the bulk of audit interventions in most administrations. Although less deep, desk audits allow for a greater coverage at lower cost of potential errors in tax returns (deliberate or accidental). Increasingly such verification actions involve automatic cross-checking of returns against other data held by the tax administration, including identifying anomalies compared to returns of other taxpayers in similar situations. In all of these cases, where serious issues are found they can be escalated to a limited scope or comprehensive audit.

While the primary purpose of audit in terms of the audited taxpayer is to determine whether the information underpinning the tax assessment is correct or not (including whether criminal activity was involved), audit has a wider role in supporting tax compliance, including a "ripple-effect" on social norms when powers are seen to be utilised appropriately.

In broad terms, the ***wider purposes*** of audit are:

- to *provide a deterrent* – to ensure high levels of compliance and to discourage fraud at one extreme and lack of due care and attention at the other, it is important that there is the possibility that taxpayers may be subject to audit and review (bringing it with it significant resource costs from being involved in an audit);
- at a wider level, to *enhance the trust* of taxpayers in the fairness and effectiveness of the tax system and thus to help reinforce social norms;
- to *identify generic issues* of potential concern to the functioning of the tax system, including issues with the operation of tax law; broader compliance concerns or emerging risks; areas requiring further guidance and explanation; and problems with particular administrative processes, e.g. deadlines, forms, communications etc.

In the survey done as part of this report, most tax administrations rated checking the correctness of tax returns as of highest importance. This was followed by the deterrence effect and issues to do with the wider functioning of the tax system (including the use of audit to ensure that the risk criteria influencing audit selections were valid). There was also a clear view among the tax administrations surveyed that the role of audit would expand as regards to identifying wider tax system issues and in auditing third parties involved in compliance by design processes.

3.2. The mix of activities changing the role of tax audit

As discussed in previous chapters, in light of changes in technology, the increased availability of data, the emergence of new third party providers and analytical tools, tax administrations are more intently looking at how they can adapt their business models, service offerings and design approaches. This has short and longer term implications for the role of audit.

With approximately one-third of the staff of 2017 TAS participating tax administrations working directly on audit activities it is not surprising that tax administrations are looking for ways to use audit capacity more efficiently and effectively. The general trend across tax administrations is that one-to-one traditional audits have become more risk based with increasing use of advanced analytics and rules-based systems to identify

potential anomalies and higher risk activities or transactions. Additionally tax administrations are looking for improving effectiveness and efficiency of tax audit by:

- **limiting the scope and intensity** of an audit based on improved risk selection;
- **enhancing the effect** of tax audit from one taxpayer to multiple taxpayers e.g. with a system audit, audit of service providers, but also with smart use of media and communication; and
- **improving the tax audit process** by better use of data and data analytics, leveraging on work done by other parties and using statistical audit techniques and standardisation.

This section discusses some of the areas where audit and the role of auditors might develop in the coming several years, including changes already underway. This is split into:

- proactive engagement with taxpayers, designed to influence taxpayer behaviour and outcomes;
- leveraging taxpayers' natural systems;
- further refinements to audit selection.

3.2.1. Proactive engagement with taxpayers

Proactive engagement covers a wide set of activity aimed at achieving better outcomes as regards taxpayer compliance. These activities are generally provided on a one-to-many basis, minimising the need for one-to-one reactive interventions. *Inter alia,* these can cover the provision of guidance and education aimed at informing and avoiding mistakes or errors, and joint approaches to develop processes or approaches that improve access and certainty. Simple examples include better education of taxpayers on filing deadlines, guidance that responds to identified errors or misunderstandings or providing nudges at appropriate points.

Proactive engagement can also help to minimise the need for audits in situations where taxpayers are not actively seeking to be non-compliant or to take tax positions that they know will be challenged. To do this effectively such engagement needs to address underlying issues which can give rise to audit, in particular how to give tax authorities trust that the systems and processes used by the taxpayer are reliable.

The key to the success of such approaches is harnessing auditors' experience and knowledge of where things can go wrong and of ways to mitigate that happening.

Some examples of such proactive engagement involving auditors are:

Co-operative compliance programmes

The increased use of co-operative compliance programmes for large business is discussed in Chapter 2. Such programmes draw from the learning of auditors and audits as they provide valuable information about aspects of a business, including how or how well they consider control over tax risk is maintained and therefore what the entry requirements are for such programmes. Control of risks is a combination of how a business manages tax risk internally and its communication with the tax administration. Formalising this learning in co-operative compliance programmes gives both business and the tax administration a high degree of certainty and allows tax administrations to be more confident that risks are being managed.

To be most effective, this has to be a two way process. Tax administrations also have to adapt the way they interact with business. The commitment of business at senior management levels needs to be mirrored with a similar commitment within tax administrations. In addition, an essential component of the co-operative compliance approach is that tax administrations must actively involve and engage the taxpayer, their representatives and other stakeholders in the evaluation and development of compliance approaches. Co-operative compliance programmes do not mean that audits will not be carried out, but they are more likely to be adapted to the actual compliance behaviour of the taxpayer and – if this behaviour is positive – this will lead to using instruments such as single issue audits or checks that the arrangements are functioning well (where third party reassurance can also play a role).

Such programmes have generally been applied to large businesses which are in the low to medium risk category, but as they mature there is scope for increasingly applying them to what are seen as higher risk businesses as part of a process of assuring at least some of the risks and narrowing down the scope of potential audits. In addition, there is no reason that co-operative compliance programmes cannot be applied, with suitable adaptations, to a wider range of taxpayers. It can also bring substantial benefits to small and medium sized enterprises (SMEs) or high net wealth individuals (HNWI) in understanding their wider risks and vulnerabilities and giving greater certainty (on a "no surprises" basis). Further work on the key elements of suitable programmes for SMEs and HNWI might be worth undertaking.

One particular issue for tax administrations regarding formal co-operative compliance programmes is how to ensure that significant additional resource is not being applied to entities which are low risk without commensurate gain. Some tax administrations are finding this to be an issue in co-operative compliance programmes where an increase in communication with the taxpayer

can result in to greater use of resource than might previously have been the case. Getting this balance right may in large part just be due to a learning process on both sides, although one that might need active management. As businesses become more familiar with formalised co-operative compliance and understand the risk boundaries better, then co-operative compliance should become business as usual with more queries and issues handled through general guidance and one-to-many approaches.

Another challenge is for administrations to ensure their internal processes not only gather "actionable insight or intelligence" from such relationships, but also leverage this. Areas of concern or issues that may have broader interest or application can be addressed through a range of possible non-audit avenues, which are more effective, provide greater tax certainty and are a more efficient use of resource, both for the taxpayer and the administration. These include:

- issuing public rulings or generic guidance to clarify tax treatment on particular matters;
- working with industry groups or associations to agree an approach to an area of concern;
- using "tax alert" approaches, where the administration essentially puts taxpayers on notice about a particular tax treatment or approach; and
- re-designing tax processes to avoid error and achieve better outcomes.

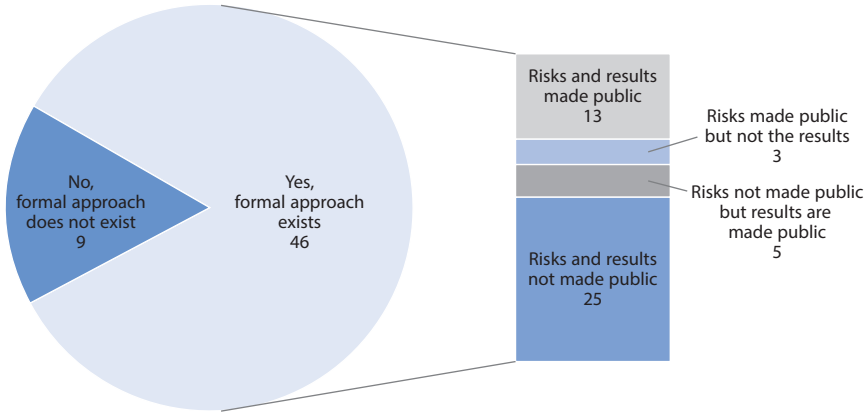
Transparency and co-operative compliance focused approaches

Even if formal arrangements are not entered into, which is likely to be particularly the case for SMEs or HNWI, knowledge of the kind of governance, transparency and information sets which can reassure auditors as to risk levels can help taxpayers to adapt their behaviour and/or provide reassurance to the tax administration.

Most administrations report having formal risk management procedures in place, with just over one-third of these making compliance risks public – the "risk flags" they use in determining their intervention and audit strategies in more or less detailed form. These administrations consider publication can enhance compliance by increasing awareness and acting as a deterrent, while at the same time reassuring taxpayers more widely that these areas are being dealt with. Those not undertaking this approach comment that they are reluctant on the basis that some entities may then try and arrange their affairs to avoid being picked up rather than with a genuine desire to manage their tax risk in the spirit of co-operative compliance.

Figure 3.1. **Existence of a formal approach for identifying, assessing and prioritising key compliance risks and whether the risks and results in addressing the risks are made public, 2015**

No. of administrations



Source: OECD (2017), *Tax Administration 2017 – Comparative Information on OECD and Other Advanced and Emerging Economies.*

Box 3.1. **General Taxpayer Classification System (the ADMIRAL) – Hungarian National Tax and Customs Administration (NTCA)**

Hungary introduced the General Taxpayer Classification System (ADMIRAL) on the 1st of January 2016 in order to use capacity more efficiently and to promote compliance behaviour. ADMIRAL has three different classifications for taxpayers registered in the register of companies or foreign taxpayers registered only for VAT purposes in Hungary: reliable, neutral and unreliable. The classification is shared with the taxpayer.

The different classifications mean different handling for the taxpayers e.g. shorter deadline for the NTCA to give a VAT refund in case of a reliable taxpayer, higher default interest in case of an unreliable taxpayer, shorter period (180 days) for the NTCA to finish a tax audit in case of a reliable taxpayer and 60 extra days to finish a tax audit in case of an unreliable taxpayer on top of the general period to finish a tax audit, which can be suspended due to a SCAC request or when an audit is linked with another audit and as a result can take more than 180 days to finish.

Box 3.1. **General Taxpayer Classification System (the ADMIRAL) – Hungarian National Tax and Customs Administration (NTCA)** *(continued)*

The criteria for the classification are determined by law and is quarterly updated and modified, if necessary, via a system check of the legal criteria. A platform is created on which every factor needed for classification is collected to check the criteria and to determine the classification easily with limited capacity (in the near future these checks and determination of the classification may be automatic).

ADMIRAL has many advantages, nevertheless it will need some fine-tuning in the future to prevent fraudulent taxpayers to use the benefits of ADMIRAL e.g. by buying reliable companies in order to classify as a reliable taxpayer.

A form of co-operative compliance "light" may be worth exploring, where without any formal relationship entities or individuals could self-assess against a range of criteria including internal controls and processes, the nature of the business and particular types of transactions. Where appropriate to the size and complexity of the business, external assurance through advisors or accountants/auditors could be sought. Sharing such self-assessments with the tax administration could then form part of risk profiling and could help both in greater assurance of tax and greater understanding of tax issues by the business or individual. It could also expand the knowledge base of tax administrations providing new information on areas where individual or general proactive engagement could be of most use. Taxpayers could also be asked to provide information as part of such arrangements on wider risk issues and concerns from their perspective, including as businesses in a competitive market place. As with co-operative compliance more generally, such a self-assessment process could be improved and refined over time by experience of continuing audits and through the use of data analytics.

For example, in Singapore, the Inland Revenue Authority of Singapore (IRAS) has introduced an Assisted Self-Help Kit (ASK) for GST-registered businesses. The ASK is a comprehensive self-assessment compliance package for SMEs that encompasses guidelines and checklists relating to a business' internal processes and GST filings, to ensure the correctness of current and past GST submissions. Where the ASK review is used by a business to apply for or renew a GST scheme, the review must be performed by or certified by a tax practitioner with GST accreditation.

Standardisation of data

Another area where the experience of auditors and audit can help improve compliance on a one-to-many basis is through the standardisation of data and agreed data sets over which automatic rules and processes can be run. With appropriate guidance this will help businesses in understanding why these data points matter, and therefore what attention they should pay to them, and will have benefits for risk assessment and for tax assessment.

An important development in this regard is the standard audit file for tax (SAF-T). The SAF-T was developed by the OECD through a task group consisting of representatives of national tax administrations, the Business Applications Software Developers Association (BASDA), accounting bodies and other interested parties. The first version was published in 2005 with an updated version published in 2010 which includes new information covering fixed assets and inventory and in the widely used XML format.

The initial goal was to define a standard data set for financial records to be of use in tax audit allowing for increased automation of parts of an audit process, with savings for the tax administration and business. Use of the SAF-T has expanded beyond that initial purpose and it is increasingly being adopted by tax administrations as a method of contributing to the filing of tax returns automatically. By standardising the data and aligning as far as possible with data collected for accounting purposes, the burden on businesses can be reduced and the access to and usefulness of the data to tax authorities in wider verification improved. This is particularly the case where SAF-T data can automatically be matched with digital data from other sources, including in making wider comparisons.

According to the survey conducted to support this report almost half of the responding countries use a form of SAF-T. Often, though, national data sets deviate from the OECD standard in accordance with national regulations. These differences increase burdens on businesses operating in multiple countries and have practical implications for the effectiveness of international exchange.

There may be advantage in further collaborative work on the SAF-T as to how it can potentially substitute for the tax return or provide a clearer underpinning to tax returns.

Box 3.2. **Polish Tax Administration: Standard Audit File-TAX (SAF-T)**

The Polish tax administration has implemented Standard Audit File-Tax – SAF-T for large business and since the 1st of January 2017 SAFT-T is also mandatory for SMEs. As of 2018 the SAF-T will be mandatory for all taxpayers including micro entrepreneurs. Taxpayers are obliged to monthly submit SAF-T for VAT via the Internet and additionally they have to provide tax auditors with the SAF-T on request during desk or field audit.

Poland has the following seven SAF-T structures (i.e. XML Schema): VAT registers, three types of income tax books, stock entries, bank accounts and invoices. SAF-T is used in case selection phase, planning phase and during investigation.

The introduction of SAF-T has shortened time needed to perform an audit, made an audit less invasive for tax payer and the monthly submission of SAF-T has improved case selection.

Box 3.3. **International standards SAF – MOSS Europe**

The European Mini One Stop Shop Council regulation, published in 2012 contains definitions for both the legal and the audit framework and also arrangements regarding to which a revenue body will conduct the audit. Both the tax-return message and the Standard audit file were defined. The standards are voluntary, but it is clear that a taxpayer will fulfil his formal obligations, when using these standards. A functional and technical solution for audit automation, using the most common standard audit software tools is under construction by collaboration in the EU programme Fiscalis.

Source: Council Regulation (EU) No 967/2012, https://ec.europa.eu/taxation_customs/business/vat/telecommunications-broadcasting-electronic-services_en.

Making tax reporting simpler for SMEs

As set out in Chapter 2, tax administrations are looking at how the new technologies and tools can make tax reporting simpler for SMEs and more embedded in their day-to-day activities. This is on the basis that the easier it is to comply (and the harder not to), the more people will do so.

The experience of auditors is crucial in this regard as they will have knowledge of common errors made by taxpayers as well as the opportunities for deliberate underreporting. This points to:

Engagement with taxpayers: on how they can fulfil their tax obligations in the easiest way. For example, guidance can be given through multiple sources (tax offices, publications, internet, video conference, etc.) or through third parties (such as financial institutions) in one-to-many formats. This could include detailed guidance as to how best to keep records, bookkeeping (including available sources of free or low cost software) and how to calculate profits and VAT. This should always be done against the understanding of the many competing demands on a small business and the inherent difficulty of parts of tax law. For example, some tax administrations are now providing options for small businesses to store their records on line using the tax administration's systems. In China, the SAT has facilitated on-line forums providing assistance with tax advice both by the participation of tax officials to correct misleading data and by promoting the profile of participants whose advice is accurate and helpful.

Gathering auditor insight: involving auditors together with taxpayers in setting out the core elements of how technology can be used to aid compliance can make a significant difference. Applications themselves can either be designed in-house or by third party developers (where competition can spur innovation). Where such applications are developed externally, tax administrations will need to determine whether they need to play a role in testing and possibly certifying such applications. This could help establish a set of trusted products in the market place and give taxpayers higher assurance that if used properly their interactions with tax administrations, including through audit, can be minimised. This comes with a cost, though, and may be a useful area for further work on different alternatives.

Box 3.4. **Engagement with taxpayers – Estonia**

Since 2016, Estonia has had a strong focus on consulting taxpayers, working in co-operation with taxpayers and providing assistance. The aim is to improve taxpayers' trust in the tax authority both to influence compliance attitudes but also to provide taxpayers the information they need in order for them to be more confident in their tax matters.

Box 3.4. **Engagement with taxpayers – Estonia** *(continued)*

The engagement with taxpayers takes place through various channels:

- By phone: for example discussions with the taxpayer on specific tax issues that appear to be inaccurate, asking them to have a fresh look and make necessary changes.
- By e-mail or text messages: pointing out individual problematic issues or giving specific instructions on how to comply, for example with certain groups of taxpayers.
- By consultations at the premises of the Estonian Tax and Customs Board.

This approach has resulted in both corrections being made to tax declarations and improvements in taxpayers' attitude towards the tax authority. In addition, this approach has resulted in a faster and more accurate risk selection process, allowing the Estonian tax authority to identify taxpayers with higher tax risks and use resources more efficiently. Engagement with certain groups of taxpayers, for example those potentially committing tax frauds, is of course more problematic. In those cases the Estonian Tax and Customs Board uses different tools, such as audit and investigation.

Source : Estonian Tax and Customs Board (2017).

Early intervention

Auditors are also able to play an important role working with data analysts on how to identify markers of emerging risks to the viability of a business which might adversely affect the payment of tax. Against the background of a significant increase in the flow of data, including from third parties, risk models can be developed which allow for early interventions to safeguard tax. This may range from powers to put an attachment on assets where there is high probability of failure, to making sure the business is aware of the sources of support that might be available to it.

Payment thinking is another area where administrations may want to look at a widened role for auditors. The concept outlined in the publication *Working smarter in tax debt management* (OECD 2104), was developed by the Swedish Tax Agency, and encompasses the expectation that all staff will be alert to possible tax collection issues (lacking viability of the tax debtor-business, tax payment difficulties, etc.) faced by taxpayers. As well as early interventions, audit itself may positively contribute toward collection of taxes if collection issues are taken into account in the audit process (taking into

account possible third party liabilities, asset positions etc.). When it becomes clear that a tax audit will result in substantial corrections and the financial position of the taxpayer does not allow full payment on time, the auditor can notify the tax collector to set up the first steps in the tax collection process.

Box 3.5. **Switzerland: Bottom-up strategy**

In 2014 Switzerland introduced a process to integrate the tax experts' (or auditors' or other staffers') personal appraisal of a general risk or their idea of the possible business risk in the risk selection model. The process is as follows:

- From their daily practise with VAT, tax experts develop ideas of which businesses or behaviours might be risky and therefore should be audited more often than the average taxpayer.
- The tax expert submits an appraisal of a general risk or a new idea, together with some basic documentation to support his idea, to the team which is in charge of evaluating the tax risks.
- The idea is analysed by this dedicated team (tax auditor and data analyst)
- If the outcome of the analysis is positive i.e. the idea seems to be good, the idea is tested in a sample of field audits and evaluated.
- If from the evaluation the performance of the idea results higher than usual risk oriented cases, the idea is integrated as a new risk indicator.

Box 3.6. **Payment Thinking in a multilateral case involving Italy and the Netherlands**

Representatives from Italy and the Netherlands discussed a common strategy in a multilateral case in which they feared embezzlement was likely. To reduce the risks collaboration between Italy and the Netherlands was deemed necessary, including the involvement of both auditors and tax collectors.

A common strategy was adopted to take conservancy measures at the moment of the notification of the assessments. The request for conservancy measures could only be executed successfully when it would be legally possible in both Italy and the Netherlands.

Without such collaboration, the assets of the taxpayer would probably have disappeared before tax could be collected.

Source : Netherlands Tax and Customs Administration (2017).

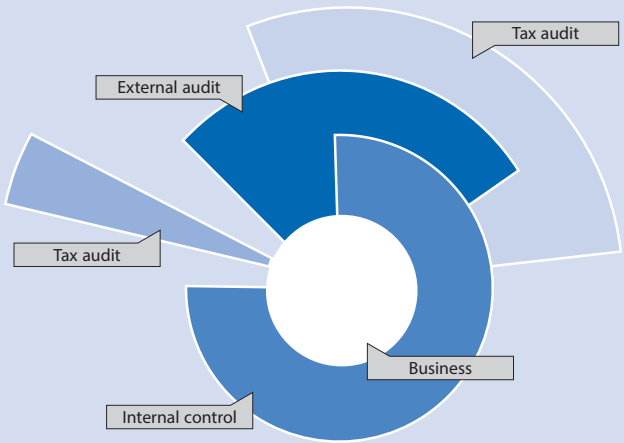
As part of this administrations which do not already do so might wish to improve their tracking and reporting of the collection of tax assessed as a result of audit. An example of established processes for measuring tax assessed through verification is that undertaken in Spain by the State Tax Administration Agency (AT). AT has for the last decade utilised formal co-operation between tax audit and tax recovery services to ensure the collection of the taxpayer's debts, with processes commencing before formal assessments are made in order to reduce the collection risk.

3.2.2. Natural systems

Tax administrations have long leveraged the verifications done by third parties or by taxpayers own internal systems. This results in fewer or more focused audits. An example of this is set out in Box 3.7 in the "layer model" of the Netherlands Tax and Customs Administration.

Box 3.7. **Use evidence from others in audit: The Netherlands' layer model**

The audit method of the NTCA starts with a risk analysis model to determine the appropriate scope of the NTCA's audit. The analysis takes account of the quality of the data provided by the taxpayer as well as the robustness of the processes which generated the data. Consequently, the NTCA does not conduct any audit activities that have already been carried out to an adequate extent by the auditee or the auditee's auditor and/or tax service provider. The NTCA achieves this by reviewing how it can make use of the audit evidence that has already been collected by others. The audit method is illustrated in a layer model.



Box 3.7. **Use evidence from others in audit: The Netherlands' layer model** *(continued)*

This model is based on the principle that an organisation is responsible for the appropriate management and controls of accounting for its operations. Good-quality information on business processes is an essential element for good internal control of a business and is therefore the responsibility of management. The layer model is based on the principle that many businesses will have implemented internal control measures and procedures to provide assurance for the quality of this information (the internal control layer). The layer model also shows that external audits (such as done by external auditors) can often provide a high degree of certainty about the quality of some of the information relevant to tax audits, including the quality of internal controls. The size of these layers varies in each organisation and, consequently, the degree to which the NTCA can rely on the internal control system or external audits also varies.

Source : Netherlands Tax and Customs Administration (2017).

Technical systems and third parties

As previously mentioned auditing knowledge and experience can be used in helping to facilitate the design of particular applications and software. It can also be used to assist thinking about how such applications can fit together and can be combined with other data flows, whether internal or external, to reduce burdens on taxpayers and increase the extent of verified reporting. In line with this tax administrations should consider their role in auditing technical and software systems, such as cash registers or recordkeeping systems, and how data can be exported securely to the tax administration.

With third party service providers playing an increasing role in supporting businesses and individuals in meeting their tax obligations, tax administrations may want to consider how they can best leverage this to provide enhanced assurance. In some countries tax administrations educate and advise service providers to improve the quality of the accounting service and the resulting tax returns to minimise the need for an audit. Another option is for tax administrations to consider licensing or certifying service providers and instituting checks, including audits as necessary, of their activities and the impact on the reliability of tax returns.

Box 3.8. **Invoice software certification – Portugal**

Portugal uses (mainly in the cash retail business) invoice software certification to mitigate sales suppression through the use of external programmes (such as zappers) and also to ensure that if these kinds of features are used in software, the developer will be the responsible.

The certification of invoicing programmes depends on the cumulative existence of five requirements:

a. exporting possibility of SAF-T;

b. enabling the signature of invoices and other documents;

c. access control of the electronic system;

d. not allowing amendment of the tax information, without aggregating amendment evidence to the original information;

e. fulfil all other technical requirements approved by an order of the Director General of the Tax and Customs Authority.

Certified invoice software became mandatory for bigger companies in 2011; at this moment certified invoice software is mandatory from EUR 100 000 turnover.

Source : Autoridade Truburária e Aduaneira (2017).

3.2.3. Audit selection

The general trend towards more targeted audit is expected to continue as wider risks in the tax system are dealt with through the ability to verify more returns through third party data and by utilising more one-to-many interventions. Random audits will continue to be used by some tax administrations to build a wider picture of tax risks, helping to ensure that risk models adapt and are therefore accurate and up to date. They also can play a role in assisting with the measurement of tax compliance outcomes. However, random audits are an expensive process for tax administrations and taxpayers, particularly regarding smaller businesses or individuals. This has made a number of tax administrations reticent to use them, and instead they have looked to understand emerging risks through analysis of data domestically and in co-operation with other tax administrations.

Risk models have become more sophisticated over time both because of the feedback from auditors, greater understanding of international risks, as well as increased availability of data and use of data analytics.

Some of the main data sources used by tax administrations are listed in Box 3.9. Further work would potentially be useful both on identifying and updating relevant data sets; examination of how to improve access to data held offshore; and further consideration of data protection and security issues.

Box 3.9. **Data sources**

Traditionally the majority of data available to tax administrations was supplied by taxpayers in forms, declarations and tax returns. Lower storage costs coupled with advances in analytics capabilities have increasingly allowed administrations to not only source more third party data in support of new approaches and products, but also facilitated the better management of tax risks.

- *Data from devices:* data can be collected from devices that register transactions such as cash registers and trip computers for taxis and trucks, but also gate registrations or barriers and weigh bridges. The registrations are made for non-tax purposes, but can also be used during an audit, as long as the data is not altered or deleted. In Switzerland taxi drivers as well as others who drive for commercial purposes are obliged to use a tachograph in their taxi which registers the trip period and rest period of the car. These tachographs help to determine the turnover of the taxi driver. The trip time will be reduced with an estimated percentage of journeys without customers. The result of these calculations is compared to the declared turnover and – in case of difference – rectified by the tax auditor.
- *Data from banks, merchants or payment service providers*: This allows direct verification of income or assets reported by the taxpayer. Some countries already receive transaction details or transaction totals for taxpayers on a regular basis. For example HMRC receives data from processors of credit and debit card transactions to support the identification of suspected suppression and evasion. This data is also checked against VAT returns and allows for stratification on location, type and amounts of goods or services sold.
- *Data from suppliers*: Collecting data from suppliers, either directly or through the taxpayer, allows a more complete picture to be drawn about the activities and income of the taxpayer. For example in Estonia taxpayers are now required to provide information on transactions with other suppliers involving VAT. This allows the tax administration to match both sides of a VAT transaction allowing it to uncover risks of potentially fraudulent transactions.
- *Data from the customer*: This is easiest in cases where the number of customers is limited and known. When the customer is unknown revenue bodies could request and use unstructured data from the taxpayer.

Box 3.9. **Data sources** *(continued)*

For example in the Netherlands there is no import duty due (exemption) when the value of the imported good does not exceed a certain amount and as a result the reported value trends to be lower. The NTCA can check with customers the correct value of imported goods reported by courier companies by asking them how much they paid for the item that they bought on-line. The NTCA can decide to ask for information from the customer based on risk selection e.g. when there seems to be a discrepancy between the weight of the imported good and the value reported by the courier company.

- *Unstructured data concerning the taxpayer*: Increasingly electronic traces are being left relevant to business activities and transactions which can either be imported by the taxpayer into their records through applications or can form part of the background material requested in audits (subject to legislative powers). These can range from emails and texts, to records of business appointments to postings/advertisements on social media. For example Sweden has gathered information on poker players via online tournaments in order to find individuals that have not reported their gains to the tax agency.
- *Data from other government agencies:* Data held by other government agencies for example for licencing, regulatory or social security purposes can be relevant in verifying tax returns or in risk assessments. For example Singapore uses vehicle records and employee Central Provident Fund contribution data to help determine whether a company has a business presence, thus indicating if it is active or dormant. New Zealand has collected open sourced data on property and property related transactions from a number of central and local government agencies involved in property, and combined with taxpayer specific data to create a data pool to be used to identify compliance risk areas across the property sector and to select candidates for targeted interventions.
- *International data:* New international exchanges of data commencing under the Common Reporting Standard and Country by Country Reporting will exponentially increase the quantity of data available on accounts of taxpayers held overseas. This will provide useful information for audit and case selection processes. In the case of CRS data it will be possible to undertake traditional data matching against individual taxpayers. Some administrations may wish to disclose information to taxpayers proactively and, where sufficiently complete, include this in pre-filled tax returns.

Advanced analytics is also playing an increasing role in audit selection. Standard advanced analytics techniques and approaches are well suited to this type of activity as they enable administrations to learn directly from the outcomes of past interventions. For example analysis of previous audits which have resulted in large adjustments might show that there was a pattern of particularly high or low values in some components of the tax return. This might then provide a basis for future audit selection (with further testing to check the validity of those insights). The set of techniques which allow administrations to identify such characteristics fall under the heading of supervised learning.

Where administrations have used such techniques with a broadly representative sample of taxpayers, this can be a highly effective approach. However, where this is not the case, supervised learning techniques may give unreliable results since the model developed can only learn about a narrow segment of cases.

In such scenarios, administrations have begun to apply techniques that aim to identify anomalous taxpayers or returns by comparing outcomes across relevant peer groups. While these models will not always target risk accurately (since some anomalies may be perfectly innocent), they are capable of uncovering wholly new insights into non-compliance. Increasingly advanced analytics is looking for wider patterns based on relationships between taxpayers or connected entities which can provide more information about the possible compliance attitudes of taxpayers. Such analysis can also help identify whether particular structures or patterns of relationships pose higher risks.

Box 3.10. **Social Network Analysis – Singapore**

IRAS has been expanding the use of advanced analytics in identifying risks and selecting cases for audit. The most recent enterprise-wide tool added to their suite of analytics solutions is Social Network Analysis. Social Network Analysis shows relationships between people, organisations and other connected entities. It is used to enhance IRAS' capability in identifying and understanding risks embedded in complex layers of structures and relationships. IRAS is better equipped to uncover tax fraudsters that seek to conceal their identity behind complex networks. Social Network Analysis is used to augment IRAS' existing risk-detection methodologies, such as business rules, predictive analytics models, etc.

Social Network Analysis enables IRAS to profile risk more holistically. Traditional risk assessment centers on entity and transactional risk whereas Social Network Analysis provides an added dimension by assessing network risk as well. These are collectively translated into overall risk scores, which help to inform IRAS' prioritisation of cases for in-depth review.

Box 3.10. **Social Network Analysis – Singapore** *(continued)*

The enterprise-wide Social Network Analysis system also aids auditors in reviewing cases by consolidating and displaying relevant information on the case in an easy-to-consume manner, for example, network visualisation.

Source : Inland Revenue Authority of Singapore (2017).

In addition to audit selection, the use of technology has also enabled improvements in the process, in particular the use of robotic process automation (RPA). In the past the assembly of files for audit has been labour intensive and time consuming since the relevant material might be held in legacy IT systems that could be difficult to access. Increasingly RPAs are being used to assemble audit files, often in a matter of minutes. As they develop and start to embed artificial intelligence processes, such applications can be expected to perform pre-audits, for example extracting summaries of relevant information, including comparative information, as well as identifying missing information and, where possible, supplementing it directly from other data sources or requesting it from the taxpayer.

Box 3.11. **The Auditor's Workbench programme – United States**

The Auditor's Workbench programme ("AW") is an application used by U.S. auditors to identify areas of international compliance risk on a tax return. The application allows revenue agents to import select international information from U.S. corporate and partnership income tax returns, as well as international information returns, filed by taxpayers into a database. Once the information is in the database, auditors can generate reports which provide detailed information on line items in the tax return, comparative reports which allow auditors to compare information across multiple tax years, standard reports which focus on particular strategic international issues, and finally the flexibility to create custom queries based on any criteria the auditor is interested in. The AW is particularly useful because it provides an efficient means of analysing significant amounts of tax return data, which in turn saves the auditor time in performing a risk analysis and developing an issue of non-compliance.

Source : Internal Revenue Service (2017).

Box 3.12. **iCase Singapore**

Singapore's iCase provides a consolidated dashboard view of a company to assist auditors in their review of companies' tax returns; it also flags potential risky areas that may warrant a closer look. iCase enables auditors to obtain a holistic view of the taxpayer's financial and tax affairs without having to search for the same information across different systems. iCase offers a set of useful information such as profile of the company, income and expenditure (including comparisons against financial statements), ownership of real properties as well as industry benchmarking of turnover and profitability. It also contains a compliance scoring methodology.

iCase is most helpful in gathering much of the information needed by an auditor into a single platform. Auditors leverage it to detect errors in tax deduction claims and flag out potential compliance issues for further examination. The data in iCase is collected from several internal and external sources. It is an in-house product developed in Excel. At present, it is only in use for corporate taxpayers (and for corporate tax only).

Source : Inland Revenue Authority of Singapore (2017).

More active engagement with industry associations, taxpayers and other government agencies can provide administrations with valuable insight into how to improve services and enhance compliance, including through possible changes to tax policy. It is important that internal processes exist that ensure the knowledge from audits and auditors is increasingly being used in proactive approaches aimed at making tax obligations simpler to comply with and in the upstreaming of tax reporting and recording closer to an event with possible tax consequences.

As more tax is assured through systems approaches – the automatic integration of data sources and third party verifications and processes – tax auditing will become more concerned with the functioning of the system as well as the exceptions. Getting such auditing right will be of huge importance given that it will be concerned with the robustness of one-to-many systems, where the consequences of failures or exploitation of vulnerabilities can have greater consequences and be of much greater scale compared to one-to-one audits.

Note

1. https://www.oecd.org/tax/administration/37589900.pdf.

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Chapter 4

Co-operation on cross-border audits

Taxation has significant global dimensions with a large number of businesses operating or trading in multiple countries. Also individuals are becoming increasingly mobile and may have sources of income or taxable transactions in different countries. In the face of aggressive tax avoidance and evasion, co-operation between tax administrations is increasingly important. Current experience with international co-operation in simultaneous and joint audits shows that co-operation can be valuable – for tax administrations as well as for multinational enterprises – in obtaining tax certainty.

Additionally, it is expected that increasing exchange of information will lead to better identification of common international issues which may be best resolved by international co-operation. Tax administration should therefore further explore the potential solution to international issues and to improve the effectiveness of multilateral approaches.

This chapter discusses the possibilities for greater international co-operation on risk assessment and multilateral audits and shares current experience on co-operation, looking at joint risk assessment, simultaneous tax examinations and joint audit to the extent that such co-operation is in line with domestic legislation and international standards.

4.1. Introduction

Taxation has significant global dimensions with a large number of businesses operating or trading in multiple countries, often through complex organisational and financial structures. Individuals are now also increasingly mobile and may have income sources or undertake taxable transactions in different countries from those in which they are resident for tax purposes, either directly or remotely. The expansion of the global digital economy continues to break down the barriers to international business, transactions and the movement of funds.

This has been a challenging environment for tax administrations in the face of growing instances of aggressive tax avoidance and evasion, facilitated by the lack of visibility of many offshore transactions, activities and accounts. Co-operation between tax administrations has been extremely important in this context. Under the previous international architecture this could only go so far. The joint G20/OECD's Base Erosion and Profit Shifting (BEPS) project launched in 2013 has greatly expanded the possibilities to detect and deter aggressive tax avoidance and evasion by delivering important changes to the internationally agreed rules that govern where profits are taxable as well increasing the flow of information between tax administrations, for example on rulings and Country by Country reporting.

There has also been a significant increase in the flow of information through the work of the Global Forum on Tax Administration on the exchange of information as well as the expansion in the number of countries joining the Multilateral Convention on Mutual Administrative Assistance. This has been taken to the next level in terms of the volume of information to be exchanged as a result of the agreement of automatic exchange of financial accounts on a global basis under the Common Reporting Standard (CRS) and the Foreign Account Tax Compliance Act (FATCA). At the same time there has been expanded and deeper co-operation between tax administrations, including through the Joint International Taskforce on Shared Intelligence and Collaboration (JITSIC) and other FTA groups. Taken together these developments have given tax administrations significant new tools and information to help ensure that the right amount of tax is paid and to restore taxpayers' trust in the functioning and fairness of the global tax system.

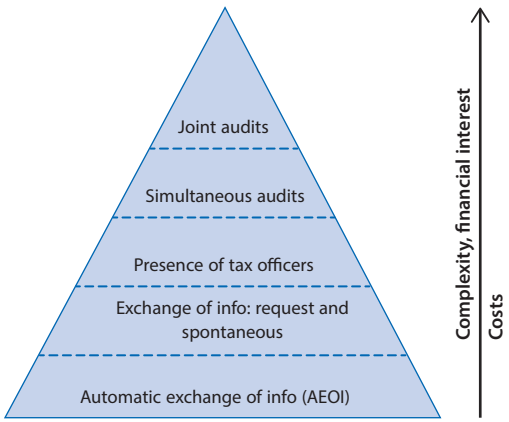
In the survey conducted to inform this report, a majority of the responding countries reported that they expected increasing exchange of information would lead to better identification of common issues that may be best resolved by international co-operation. In addition taxpayers, more specifically MNEs, are looking for an increased level of co-operation between revenue bodies to facilitate international compliance and provide for quick issue resolution and tax certainty in the international context (IMF/OECD [2017]).

Against that background, this Chapter looks at the possibilities for greater international co-operation on risk assessments and international audits, to the extent that such co-operation is in line with domestic legislation and international standards.

4.2. Current experience of co-operation

When international tax risks emerge during a domestic audit there are several possibilities for cross-border exchange of information for tax purposes. This is illustrated in Figure 4.1 (Van der Hel-van Dijk, 2016). In addition to the exchange of particular items of information (not covered further in this report) co-operation on risk assessments, simultaneous audits and joint audits could also be used.

Figure 4.1. **Approaches for cross-border exchange of information for tax purposes**



Explanation: For more complex situations where the parties have common or complementary interests and exchange of information and/or presence of tax officers abroad seem insufficient, countries may need more intense forms of co-operation such as simultaneous or joint audits.* The overarching term "international audit or examination" can be used to refer to these types of "tax audits" and the many forms they may take. An international tax audit can be conducted both bilaterally and multilaterally.

* Note that in current laws and regulations and in the administrative practice various terms are used, e.g. simultaneous audit or – examination, bilateral or multilateral audit or – examination, multilateral control (MLC), etc.

4.2.1. Multilateral risk assessments

While simultaneous and, to a lesser extent, joint audits are being carried out by tax administrations, there have been limited and isolated instances of joint risk assessment as part of "business-as-usual". These have generally been conducted on either on a bilateral (rather than multilateral) basis or targeted at specific risk areas. Audit lists following domestic risk assessment processes have sometimes been exchanged between countries with regards to businesses operating in both countries. Discussions have sometimes then taken place on businesses which might be suitable for an international audit. Exchange of information in accordance with the legal framework of a bilateral or multilateral tax convention or a tax information exchange agreement has also commonly been used as a precursor to domestic and multilateral risk assessments.

Accordingly, there is scope to develop enhanced multilateral processes for risk assessing multinational enterprises. Recently, a number of FTA members have agreed to pilot a multilateral international compliance assurance programme (ICAP) which builds on the principles of domestic co-operative compliance programmes, but also on the common data set of Country-by-Country Reporting that will be available for all revenue bodies in the FTA from 2018. This pilot project will involve undertaking a co-ordinated multilateral risk assessment on a small set of low and medium risk multinationals (MNEs).

The ICAP process is designed to be a quick and internationally co-ordinated way of assuring the activities and transactions of MNEs, while isolating quickly key risk areas for further attention. The underlying drivers of this pilot are to test whether this may help minimise MAP disputes by increasing collaboration and co-operation between MNEs and multiple tax administrations at an early stage; to increase tax certainty for business; and to positively influence taxpayer behaviour. The lessons from this pilot will be important in developing a platform for multilateral risk assessments for MNEs and may lead to an expansion of the pilot.

Given the high degree of similarity in respect of the current areas of focus as discussed in Chapter 2 another option possibly worth exploring further is the possible regular exchange of domestic risk ratings for MNEs with other countries where they have a presence. This would facilitate a deeper co-operation and collaboration between tax administrations in respect of MNE risk profiles and could create a pathway for the exchange of intelligence related to emerging tax issues for this taxpayer population. It would require that the risk assessment framework was also communicated and explained so that the receiving jurisdiction was able properly to interpret the rating. This could be a useful input into domestic risk assessments and could help facilitate general discussions of risk assessment frameworks as well as the application in specific cases. It could also be a step towards working more

closely together on developing multilateral analytics capabilities for risk assessment purposes on common populations of MNEs.

4.2.2. Simultaneous tax examination

A simultaneous tax examination is a tool of mutual assistance provided for in several multilateral, regional or bilateral arrangements, including:

- In the Convention for Mutual Assistance in Tax Matters that refers to a "simultaneous tax examination" which is defined as "an arrangement between two or more Parties to examine simultaneously, each in its own territory, the tax affairs of a person or persons in which they have a common or related interest, with a view to exchanging any relevant information which they so obtain" (OECD/Council of Europe [2011], Article 8).
- The European Union (EU) Directive for Direct Taxes [1] uses the term "Simultaneous Controls" and defines this as a situation "Where two or more Member States agree to conduct simultaneous controls, in their own territory, of one or more persons of common or complementary interest to them, with a view to exchanging the information thus obtained."

4.2.3. Experience with simultaneous audits

Within the EU the European Commission has set up a programme (Fiscalis [2]) to promote co-operation between EU member states, including financing multilateral tax controls. (MLC is the EU term for simultaneous audits involving two or more countries).

Although there is a common legal basis in the European legislation,[3] this does not mean that in practice co-operation is simple due to differences in national legislation and approaches. The European framework for international audit covers aspects of the exchange of information, delegation of competent authority, presence of tax officers etc. while the framework for conducting audits is in the national legislation of the member states. In an extensive comparative research (Van der Hel-van Dijk, 2011) the following differences were exposed:

- Structure of national laws and regulations;
- Obligations of taxpayers concerning their own tax return;
- Obligations of taxpayers regarding information of third parties;
- Powers of the revenue body in conducting tax audits; and
- Legal protection of taxpayers and third parties.

Despite the differences in national legislation and audit practice, over the past two decades European member states have managed to work together

effectively in conducting MLCs. The topics dealt with can relate to different types of taxes. Traditionally emphasis has been on VAT cases, but there has been a shift in recent years towards more cases in the field of direct taxation, mostly related to transfer pricing issues.

The European report on Transfer Pricing Risk Management (EU, 2013) states that simultaneous audits or even joint audits may be useful in the context of transfer pricing, given the bilateral and multilateral nature of transfer pricing. The report also notes that taxpayers might be given a right to propose such simultaneous audits in situations where certain issues are foreseeable. During the OECD Conference of Tax Audit in the 21th Century in March 2017 the deputy tax director of an MNE shared his experiences with an MLC that has been conducted at his company by seven revenue bodies to review transfer pricing issues (see Box 4.1).

Box 4.1. **Experiences of an MNE with an MLC involving multiple countries**

While a simultaneous audit in theory is conducted by revenue bodies working "each in its own territory", this case illustrated an enhanced level of collaboration as some joint activities were performed. For example, the company made several presentations to share information simultaneously with all the countries involved in the MLC. Tax auditors from different countries paid several local on-site visits to businesses under examination and did not solely work in their own territory. The MLC was conducted in good co-operation and with an open dialogue between the company and all the revenue bodies involved. The MLC was concluded with a mutual agreement between the countries involved on the issues under examination with a consistent transfer pricing method for the company, valid in a number of countries.

4.2.4. Joint Audits

In September 2010 the OECD published the Joint Audit report where joint audits were introduced as a "new form of co-ordinated action between and among revenue bodies." In a joint audit, two or more countries co-operate to form a single audit team. The rationale is that joint audits should result in quicker issue resolution, more streamlined fact finding and more effective compliance. Joint audits also have the potential to shorten examination processes and reduce costs, both for revenue authorities and for taxpayers (OECD, 201).

The term "joint audit" as such is not a legal term, which means that in order to conduct a joint audit the legal basis has to be found in existing

bilateral, multilateral and regional agreements.[4] In practice that means that "joint audits" follow the same principle as simultaneous audit and the presence of tax officials is often limited to presence in administrative offices and/or connected to a request for information. If countries want to co-operate more upfront or pro-actively in specific cases, it is helpful if foreign tax officials can be part of the audit team, for example conducting interviews. This can be overcome to some extent provided that there is permission from the taxpayer rather than there being a legal right.

With each country having its own national law and regulations on performing tax audits, the way in which joint audits can be performed may be limited to the smallest common legal base if the taxpayer is not co-operative. It could be helpful to more fully describe what can and cannot be done in different scenarios and consider a possible minimum set of equal legal powers of tax auditors to facilitate effective international co-operation.

Box 4.2. **Pilot project Joint Audits by Germany and the Netherlands**

In 2013 Germany and the Netherlands sought to test the practical issues involved in conducting joint audits with auditors from both countries working in one single audit team. The pilot programme involved five international companies; three multinational companies listed on national stock exchanges, one company owned by a large foreign investor and one family-owned company.

In this pilot the EU Directive 2011/16/EU was used as a legal basis. In addition, to ensure that the basis for the joint audit was as robust as possible, prior to the pilot all the companies were asked to give their consent. This was necessary because under the national legislation in the Netherlands at the time, a notification procedure had to be followed before information could be exchanged with other countries. Furthermore the presence of foreign tax officials was linked to a request for information whereas in a joint audit parties are expected to work as one audit team, and share information rather than exchanging requests and answers.)

An independent evaluation team concluded that no "real" joint audits were performed in this pilot, because of the legal and practical differences in audit approach. From a theoretical point of view none of the five audit teams were able to act as "one single audit team" as in the OECD definition, due to obstacles or different approaches in all stages of the audit:

- during planning/preparation, where there were differences in case selection, audit announcement and the drawing up of an audit plan;
- in field work where audit objectives were set according to the different strategic goals of the respective revenue bodies;

Box 4.2. **Pilot project Joint Audits by Germany and the Netherlands** *(continued)*

- different audit approaches, including different methods of collecting information, such as the use of interview techniques versus evidence in writing etc.; and
- differences in judgement and reporting. The companies were looking for joint advance pricing agreements for the future as an important part of the result of a joint audit. This was not possible in each country, due to domestic legal rules.

Despite the different approaches, in practice the auditors managed to reach an enhanced level of co-operation and all cases resulted in a joint conclusion as to the tax position. Both the companies and the tax officers expressed their general satisfaction with the collaboration in this project, in particular with joint fact finding (and the advantage of sharing the information only once) and the reaching of a joint position, although the companies regretted that there were no joint APAs to cover future periods.

Source : Netherlands Tax and Customs Administration; Germany, Federal Ministry of Finance (2017).

4.3. Areas for improvements to international audits

Feedback was collected from tax managers that experienced different forms of international co-operation in MAPs, MLCs and the joint audit pilot.[5]

There was a clear demand for more international co-operation, with faster dispute? resolution seen as the main benefit as well as the potential for certainty across multiple countries and a reduction in costs, in particular from sharing information only once. Regarding tax positions, co-operation in international audits was seen as creating the opportunity for consistent transfer pricing treatment over all territories involved, avoiding multiple negotiations and reducing the chance of differences ending up in Mutual Agreement Procedures. This was seen as particularly important given the recent changes in the international tax rules and as yet uncertain application of those changes.

The feedback from taxpayers includes the following suggestions for improvement of international audits:

- Joint or simultaneous audits could be embedded in legislation, ideally with companies having the option, subject to criteria, to apply for such an audit to obtain certainty on tax issues that involve multiple countries.

- A joint audit (and preferably also a simultaneous audit) should lead to a common accepted outcome across both tax administrations and taxpayers and there should be a clear objective of providing future pricing certainty.
- To enhance efficiency and effectiveness of collaboration between revenue bodies and with taxpayers, there should be more alignment in audit approaches. (As an example the lack of alignment on the periods under investigation was mentioned. This can create ambiguity and uncertainty about the tax consequences across the whole period.)
- An appropriate timetable should be communicated with the taxpayer. In some countries national legislation can be an obstacle for international co-operation in tax audit, for example when an audit has to be conducted in a very short time period.
- A possible Code of Conduct could outline the rules of engagement between the co-operating revenue bodies, e.g. on communication with the taxpayers, agreement on the years under audit, statutory timings, drawing common conclusions etc.
- Arrangements should be incorporated for a joint settlement of the international audit result and where not possible, there should be clear and expedited arbitration procedures for the avoidance of double taxation.

Against this background – in particular that few joint audits have as yet been conducted – it is perhaps worth looking again at the robustness of the international legal basis for joint audit and ideas that could improve effectiveness and keep costs low, such as a Code of Conduct for the management of joint or simultaneous audits and the outcomes sought.

Notes

1. Council directive 2011/16/EU of 15 February 2011 on administrative co-operation in the field of taxation and repealing Directive 77/799/EEC.
2. https://ec.europa.eu/taxation_customs/fiscalis-programme/fiscalis-2020-programme_en.
3. Regulations have a direct legal importance and a Directive needs to be implemented in National laws of the Member States.
4. For a more detailed description of different types of co-operation between revenue bodies we refer to Chapter 2 of the Joint Audit Report which gives a detailed explanation of the legal frameworks that can be used for various types of co-operation.

5. Feedback was collected during interviews held with tax managers in the evaluation of the joint audit project and during this current OECD project. A few tax managers had experience with the different instruments MAPs, MLCs and JAs and were able to compare the different tools. See also Van der Hel-van Dijk, 2015.

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Chapter 5

Recommendations for better tax compliance and audits

This chapter concludes the report by recommending further work in a number of areas e.g. the core elements of tax administration and the expectations for developments, supporting easier calculation of tax and more robust and upstream verification, co-operative compliance programmes in particular for SMEs and more informal arrangements, data sources and data security covering aspects of data management and data protection and facilitating joint audits by examining potential solutions to international issues.

The emergence of new technologies, tools and third party providers is presenting tax administrations with unprecedented opportunities to reshape how they collect and verify tax revenues and reduce the compliance burden on taxpayers. This is a complex task. Redesigning how tax administration works is not based on a single new development but involves fitting complicated and evolving pieces together to form a system which needs to be dynamic and adaptable. Application of new technology can be expensive as can the use of new tools and forms of delivery and also carries implications for staffing, skill sets and organisational structure.

Co-operation between tax administrations and engaging with other stakeholders on how best to utilise these new opportunities can both decrease costs and enhance the probability of success as lessons are learnt and shared. Such co-operation can also help in informing internal policy discussions around such issues as access to data, data protection and data security as well as authentication and identification. The increased cross-border nature of business and the emergence of new forms of business also call for greater collaboration on how to manage the tax risks of international business.

As has been recommended in previous work in the Tax Administrations of the Future series, collaborating with taxpayers and other stakeholders on making tax administration user-centric is critical. In addition to looking at how tax processes can be made easier this can also include consideration of options for greater compliance by design and more joined-up whole of government approaches. Such discussions and consultations can help to build a consensus, for example on the wider sharing of data.

Tax administrations will also need to consider their internal governance processes to manage this period of intensive change, including how they make use of the wealth of expertise among tax officials as to how to improve overall outcomes. Tax administrations may also wish to review their HR strategies to make sure that they are both recruiting and growing internally the mix of skills that will be needed as administrations change the way they work.

Recommendations

As a result of the analysis in the report, a number of areas are recommended for possible future work:

- An overview note of what FTA members collectively see as the **core elements of tax administration and the expectations for developments** in the short and medium term in those areas. This will be helpful in providing a framework for the development of internal strategies and as a guide to areas where future collective work would be of most value.

- **Supporting easier calculation of tax and more robust and upstream verification.** At the micro and SME business end, apps are already becoming available to reduce time spent on tax and the need for post-filing checks. A possible project on reducing the burden of calculating tax liability and reporting of relevant information could look at the different options becoming available for different categories of taxpayers and how tax administrations could best support them. This could include for example supporting standard setting, the use of third party software and the facilitation of third party apps. There may also be value in further collaborative work on the standard audit file for tax (SAF-T) as to how it can potentially substitute for the tax return or provide a clearer underpinning to tax returns, including how it fits with evolving systems used by business.
- **As regards audit developments,** there could be value in sharing tax administration's experiences with regard to system assessment processes that are currently used. In addition, given that different approaches are taken by tax administrations in regard to random audits, it could be useful to share experiences with regard to the costs and benefits of for random audit programmes.
- **Co-operative compliance**. As a number of administrations report their interest in expanding these frameworks and approaches, it could be worth looking at the lessons to date of co-operative compliance programmes and how to ensure that they are delivering their aims without imposing excessive burdens. Guidance could also be helpful on how co-operative compliance programmes could operate for small and medium sized enterprises.
- **Data sources and data security.** With data playing a crucial role in the transformation of tax administrations, it may be helpful to produce a compendium and commentary on the different data sources used by countries both from internal and external sources, including other parts of government. A companion piece could cover aspects of data management, including the data security and data protection issues being grappled with by tax administrations and which are of critical importance in achieving the goals of future tax administration.
- **Facilitating joint audits.** A number of pilot projects have been undertaken on joint audits which are seen as an important development for enhancing tax certainty and helping to avoid the triggering of resource-intensive and lengthy Mutual Agreement Procedures. It would be useful to further examine the main lessons to be drawn from the pilot initiatives and the potential solutions to issues identified, including as regards the legal base as well as ideas that could improve effectiveness (such as a template Code of Conduct).

Please note that the forms of co-operation outlined in this chapter and the respective recommendations should not be understood as an obligation on the part of tax administrations to introduce or partake in such co-operation. In this respect, tax administrations operate in line and within the boundaries of domestic legislation and international standards.

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