COMMERCIAL TAXES MISSION MODE PROGRAM
(CT MMP)

REPORT ON INTERNATIONAL BEST PRACTICES IN VAT ADMINISTRATION

DECEMBER 2006
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Disclaimer: This paper on international practices is a collection of excerpts from leading international publications, commentary from international experts consulted by Ernst & Young during the course of the engagement and also some independent views of Ernst & Young on the various topics. Given the necessity to merge together many of these constitutive elements, explicit references have not been provided to the sources in the paper. However, adequate care has been taken to acknowledge these sources of information in the bibliography section of this paper.

Given the limited timeframe of the engagement, a paper of this nature may not be expected to comment on every aspect of VAT administration. The topics selected for this paper are based on Ernst & Young’s judgement of the needs of the VAT administrators in India and many topics have been tailored to those perceived needs. For more comprehensive discussions on the topics, the readers are directed to the various publications mentioned in the bibliography of this document.
1. Introduction

Over 120 countries around the world have completed the implementation of Value Added Tax (VAT) while several others are still considering the possibilities. Its use is so extensive that it has been estimated that 70 percent of the world’s population live in countries with a VAT and that it raises about 25 percent of all government revenue.

India is currently at a crucial stage in the introduction of a modern VAT. India presents a unique case of a State Level VAT whereas in majority of the countries across the world a system of National Level VAT is administered. This paper elucidates various practices followed internationally by VAT administrations keeping in mind the relevance of the issues presented to the Indian context.
2. Basic Principles of VAT Administration

Modern tax administrations operate on the principle of self-assessment and the VAT proposed for India is ideally suited to that approach. In addition, India is already committed and has formally adopted self-assessment across all revenues and therefore has a good basic experience in this approach. However, it will be helpful, in this paper, to restate the basic principles underlying the concept and to set out the basic preconditions for successful operation of self-assessment.

2.1. Self assessment

Self-assessment requires more than simply permitting the taxpayer to make the tax calculations and pay the amount calculated without notification from the tax administration. The concept is based on the understanding that taxpayers are, because of the information known only to them, best placed to assess their tax liabilities and that the tax authorities' efforts are best directed to identifying those taxpayers most likely to understate their tax liabilities, and focusing their scarce resources on the greatest areas of risk.

Thus, the taxpayer effectively takes on responsibility for carrying out the assessment function otherwise carried out by the tax office. In other words, taxpayers are responsible for:

- the facts relating to their own financial affairs;
- interpreting and applying the law to those facts;
- determining the amount of tax;
- making that determination with an appropriate degree of finality;
- filing the return on time; and
- paying the tax owed by the due date.

As a practical matter, this means that the tax administration pays little or no attention to the returns or affairs of majority of taxpayers, other than to carry out automated checks for arithmetic accuracy and to ascertain that registered filers have in fact filed in a timely manner and paid the amounts they themselves have assessed. The declarations of most taxpayers are simply accepted.

The modern tax management therefore relies heavily upon risk-assessment tools to determine which taxpayers' matters must be examined very closely, not merely at the audit level, but at all stages of the tax process, from registration to collection. In order for such a self-assessment system to be effective, the apparent freedom granted to taxpayers must be backed up with a supportive legislative framework and a comprehensive and integrated set of administrative processes, the main elements of which are:

- Simple and concise law;
- Minimal discretion for the taxpayers;
- Record-keeping rules appropriate to the nature and size of taxpayer’s business financial affairs;
- Comprehensive and accessible taxpayer services;
- A well-targeted audit system, leading to accurate reassessments with minimal disputes;
An effective and speedy disputes resolution service;
An appropriate and fairly applied penalty regime;
Well-designed processes to manage the recording of the receipt of returns and payments, and the identification of non-registrants, stop-filers and non-paying taxpayers; and
Effective IT support across all functions.

International experience has shown that this extensive reliance on self-assessment is the basic strategy that permits tax agencies to achieve high rates of voluntary compliance with ratios of 500 to 1000 or more taxpayers per tax official.

2.2. Voluntary compliance

The promotion of voluntary compliance is the primary objective of revenue authorities. In order to achieve high levels of voluntary compliance, taxpayers and their representatives must have a good standard of services, which help them determine their obligations under the laws and to complete the steps required to acquit those obligations.

It is relevant to mention here that voluntary compliance is promoted by an awareness of rights and expectations of a fair and efficient treatment and the existence of clear, simple and “user-friendly” administrative system and procedures. In other words, voluntary compliance is enhanced when it is easier for taxpayer to do so.

Therefore, the Revenue Authorities can undertake the following to facilitate voluntary compliance:

Outline and communicate to taxpayers their rights and obligations as well as the available complaint procedures and redress mechanisms;
Provide an accessible and dependable information service on taxpayers rights and obligations with respect to the law;
Deliver quality information and treat inquiries, requests and appeals from taxpayers in an accurate and timely fashion.
3. Strategic management of VAT administration

The fundamental task of any tax administration always will be to maximize revenue compliance in terms of the current law. The range and complexity of the different taxes collected, national attitudes towards tax compliance, resource constraints and managerial and operational capacity combine to make this a highly complex task.

Management approaches to the task differ quite widely between countries, but the experience of the most effective revenue administrations is that the greatest compliance gains are achieved by adopting an integrated approach to performance improvement, which provides clear organizational direction and leadership through:

- Developing a good understanding of the environment in which the organization operates;
- Selecting and communicating initiatives and clear organizational statements directed at performance improvement;
- Aligning all organization decisions to the stated aims (including those related to staffing, funding, technology, process and organizational design); and
- Objectively and regularly monitoring organizational achievement of the aims

A key mechanism for enabling the Commissioner to lead the organization through this process is the adoption of a structured strategic management system. While strategic management differs between organizations, certain themes are common to most approaches.

3.1. Preliminary examination

As a prelude, an in-depth diagnosis of the existing revenue structure, its mandate, its workload, priority areas etc. would be useful to get a general idea of how effectively and efficiently the revenue administration is currently performing. Such preliminary examination would provide a context for the diagnostic exercise and help direct attention to critical weaknesses. Three sets of indicators are provided below for this purpose.

3.1.1. Indicators of Nature and Scale of Operations

Quantitative Indicators

- Number of registered taxpayers;
- Number of large taxpayers who account for 80% of tax revenues;
- Number and frequency of declarations (i.e. tax returns) processed annually;
- Amount of taxes collected annually; Amount of taxes in arrears; Amount of taxes refunded annually
- Number of employees: Managers; Technical staff; Support staff

Qualitative Indicators

- Overall organizational structure; Number of offices at the Regional and Local levels
3.1.2. Indicators of Effectiveness

Quantitative Indicators

- Total revenue collected/ Annual revenue collection target
- Total revenue collected/GDP
- Tax Gap = \(1 - \frac{\text{Total revenue collected}}{\text{Potential revenue}}\)
- Number of tax declarations filed/ Number of registered taxpayers.
- Number of tax declarations received on time/ Total number of tax declarations filed.
- Amount of taxes paid voluntarily by taxpayers/ Amount of taxes payable on the basis of tax declarations.
- Additional taxes assessed after investigation and audit/ tax liability declared.
- Amount of additional assessed taxes upheld in appeal/ Amount of additional assessed taxes challenged in appeal.
- Amount of additional taxes collected/ Additional taxes assessed.
- Amount of tax arrears recovered/ Total amount of tax arrears at the beginning of an year.
- Number of cases of tax evasion, customs fraud or smuggling successfully prosecuted each year.

Qualitative Indicators

- Perception of taxpayers regarding:
  - Risk of detection of non-compliance and severity of consequences.
  - Quality of assistance provided by the department to enable taxpayers to comply with their legal obligations.
  - Effectiveness of the department in resolving taxpayer problems.
- Public perception regarding the degree of corruption in the department.
- Department morale and self-image.

3.1.3. Indicators of Efficiency

Quantitative Indicators

- Average number of days taken to identify and notify Stop-filers and Non-filers
- Non-payment or underpayment of declared tax liabilities.
- Number of taxpayers/ Number of employees
- Administrative Costs/ Total Revenue Collected.
- Direct and indirect compliance costs incurred by taxpayers. These would include costs related to:
  - Legal advice to understand and interpret the tax laws.
  - Preparation and filing of declarations.
  - Payment of taxes.
  - Filing of objections and appeals against assessments.
- Getting refund of excess taxes paid.
Information collected for the above indicators should cover both the actual performance of the department and the corresponding performance targets, if any. Various sources can be tapped to compile the information. These include national accounts; tax laws and regulations; statistical reports; unpublished information available with different functional areas; and interviews with managers and staff of the administration as well as with a representative sample of taxpayers and other stakeholders. It is likely that information for all the indicators mentioned above may not be easily available. In such cases, statistical sampling may be used. Where feasible, it would be desirable to compile the quantitative information for a three to five year horizon. Besides giving an idea of the size and complexity being dealt with, the information generated by the indicators would help pinpoint revenue administration's weaknesses.
3.2. Designing a strategic framework

Keeping in mind the findings of the above exercise, the next step would entail developing a strategic framework for performance management. The key steps to development of a strategic performance management framework are:

- Develop mission, vision and values statements
- Conduct environmental analysis
- State broad strategies
- Establish strategic objectives
- Develop action plans and allocate projects
- Implement the plan, ensuring ongoing alignment
- Monitor performance against plan
- Feedback findings

The following diagram outlines the key steps in establishing a strategic management framework for a tax administration.
The following section provides a brief explanation of each of the above steps.

3.2.1. Foundation statements

Mission – it is important to develop a clear, agreed mission statement based on wide internal consultation. The purpose of a mission statement is to state the organization’s fundamental reason for existence. Tax administration mission statements generally focus on collection, quality of service and enforcement. It is quite common for there to also be a reference to the fact that tax collections contribute to the economy and the maintenance of the social system.

Vision - The purpose of a vision statement is to state the senior management’s view of the future shape of the organization. It is a means of motivating staff and clearly indicating direction to external stakeholders. Most vision statements will emphasize the excellence of the organization, the achievement of targets and the establishment of an effective, equitable and efficient administration.

Values - A values statement specifies the behaviours and attitudes that the staff are expected to display on the job. It also indicates how the tax administration wishes to be seen externally. There are close similarities between most tax administrations, with the most common values being integrity or fairness, honesty, professionalism, respect, efficiency, responsiveness and cooperation.

3.2.2. Environmental Analysis

This step ensures that the management is forward looking and that it will enable the organization to react appropriately and in a timely way to the internal and external pressures on it. It involves a structured environmental scanning activity during which the organization will use all available internal and external information sources to understand the environment in which the tax office operates and to identify the risks and opportunities expected to impact on the organization over the next 4 to 5 years. During this activity, the organization would review a wide range of available data including, for example:

- Statements by the central and state governments of their priorities for revenue administration, general state revenue performance and intentions for other state activities which could be impacted by the VAT office
- An analysis of the organization’s performance data so that areas requiring improvement can be objectively identified
- Views of department specialists on emerging issues and developments relative to their area
- Views expressed by stakeholders, obtained through consultation and if available, taxpayer survey data
- Staff attitudes and ideas
- International developments particularly in advanced revenue administrations, and also in neighbouring countries
- Market research of taxpayer attitudes to the organizations performance
- Formal reviews of the organization or other similar entities
Internal expert’s views including reports on reviews by organizations such as the IMF, OECD and the EU

During this part of the process, the VAT office ought also to be considering and documenting their own strengths and weaknesses as this will assist in developing the specific strategies needed to address the emerging trends being identified.

The following provides an example of some of the environmental issues identified by the New Zealand Inland Revenue Department during a recent update of their environmental scan.

<table>
<thead>
<tr>
<th>Summary of Environmental Pressures - New Zealand Strategic Document 2006</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Government priorities</strong></td>
</tr>
<tr>
<td>The Government’s priorities over the next decade are New Zealand’s economic transformation, families—young and old—and national identity.</td>
</tr>
</tbody>
</table>

**2. New Zealand in the international community**

New Zealand’s economy is significantly influenced by the global economy, which can influence our customers’ decisions, for example, where businesses operate and where they make their investments. These decisions often have flow-on tax implications. Three examples of where we will need to focus are:

- The increasing effect of globalization on New Zealand—businesses are operating on an increasingly global basis. New Zealand is vulnerable to international developments owing to factors like our small economy and geographic isolation. Our tax base is particularly at risk because of our significant reliance on company tax as a revenue source and the relatively high foreign ownership of companies.

- The future of the trans-Tasman tax relationship—this is important because of our very close relationship with Australia.

- Our population is becoming more internationally mobile—in some cases, people living overseas may still have obligations in New Zealand, such as repaying student loans, and outstanding tax or child support.

**3. New Zealand’s diverse population**

New Zealand’s population is changing across a range of demographic variables, including age profile, ethnic diversity and dynamic family profiles. This affects the population we service.

**4. Changing age profile**
5. Ethnically diverse population
New Zealand’s population is becoming more ethnically diverse, as an increasing proportion of the population identify as Maori, Asian and Pacific peoples. One implication of increasing diversity is that different ethnic groups may have different service requirements.

6. Changing family profiles
Family structures in New Zealand are changing. The changing proportion of one- and two-parent families will have an impact on the delivery of our child support, family assistance and paid parental leave services.

3.2.3. Strategies
Virtually all strategic plans contain a set of four to eight broad strategies identified by senior management as being the major issues on which the organization must focus if it is to properly address the factors emerging from the environmental scan and achieve the stated vision. These strategies need to be big, bold and challenging if they are to assist in achieving significant and worthwhile organizational change. They should not be purely incremental.

3.2.4. Strategic objectives
In this stage of the process, it is normal to take each of the strategies and to select two or three objectives which will translate the broad aim into operational or delivery terms. This is a significant part of the process as it is largely the level of achievement of these objectives, which will dictate whether the whole plan is achieved.

In this context, objectives are highly specific statements of deliverables which are expressed in measurable terms and which are time bound. Objectives not developed in this way are open to abuse and can compromise the achievement of the whole plan.

3.2.5. Develop Action Plans
This stage of the process involves translating the high-level strategic objectives into action plans or actual deliverables. Effectively, in this model, it is the point where the strategic management system shifts from broad strategic planning to narrower business planning which is concerned with shorter-term deliverables. The action plans should clearly identify:
The tasks to be performed
The strategic objective to which they relate
The person or unit responsible for their delivery
Measurable standards by which performance can be assessed, including, ideally, measures of the quantity, quality and timeliness of delivery
The costs of implementing the action plan

3.2.6. Monitoring

It is important that the performance of all key organization tasks be monitored. Generally, this requires that performance standards be set for each major task and that achievement against those standards is regularly monitored, evaluated and responded to. The importance of doing this is that it:

- Ensures that those required to implement the strategic or operational task are held accountable for their "stewardship"
- Provides a mechanism enabling senior management to assess the performance of units and individuals, and to make informed judgments about the performance of the organization and to objectively assess the need for operational intervention where targets are not being met
- Provides a mechanism for shifting the performance focus away from simple revenue measures to all of the major operational issues which impact of compliance levels and which can be most directly influenced by management
- Supplies objective information, which can be used to review and if necessary modify the strategic plan.

The section on performance measurement provides fuller details on this aspect.

3.3. Feedback

This simply refers to the need to regularly update the strategic plan through constant reviews of performance and environmental scanning to ensure that the right issues are being addressed in the right way. The information required to enable these reviews to be conducted is gathered from evaluations of performance standard achievements and a constant updation of the environmental analysis.
3.4. Management of the process

It is common for revenue administrations with strategic management systems to establish a small full time strategic planning unit at headquarters. Such units, which need initially comprise no more than 2 or 3 staff, would not be responsible for developing the strategic plans themselves, but for assisting top management with its responsibility to do so.

Their principal functions would therefore be to:

- Gather information relevant to the environmental scanning activity, sort and analyze the information and prepare evaluations for senior management
- Facilitate the scanning activity by consulting with staff, taxpayer representatives and stakeholders and reporting findings to management
- Review periodic performance reporting data to identify the success in meeting strategies
- Assist the Commissioner with communicating the strategic plan to staff and stakeholders
- Prepare an annual report of achievements against the strategic objectives and action plans
- Advise the Commissioner on the development of appropriate performance standards
- Coordinate the assessment of financial implications of strategic plans

Given that the cornerstone of VAT administration is voluntary compliance, it is important that the management of a VAT administration strongly focuses on taxpayer services, which facilitates such voluntary compliance. A strategy for taxpayer services is therefore one of the key ingredients of a VAT administration and it has to be tightly integrated with the overall strategic management framework of the VAT administration.
4. Strategy for Taxpayer Services

An effective program of taxpayer service activities is a critical objective of all revenue authorities. The general complexity of tax laws coupled with the relatively large populations of taxpayers to be administered mean that, fundamentally, all revenue authorities must rely substantially on taxpayers' voluntary compliance to achieve the outcomes expected of them.

It is axiomatic that to achieve high levels of voluntary compliance, taxpayers and their representatives must have a good standard of services to help them determine their obligations under the laws and to complete the steps required to acquit those obligations.

Revenue authorities can facilitate voluntary compliance by:

- Providing clear explanations of the law, in a form and manner and at a time suitable to taxpayers;
- Establishing arrangements that assist taxpayers meet their obligations at minimal cost & inconvenience;
- Giving accurate responses to taxpayers questions in reasonable periods of time;
- Giving refunds of overpaid taxes in reasonable periods of time; and
- Quickly resolving taxpayers' complaints

Modern VAT organizations recognise there are three distinct groups of taxpayers that require special products, services, and attention. They are those who:

- Will pay - These are taxpayers who comply with the tax law timely, accurately, and pay the full amount of the tax due.
- Can not - These are taxpayers who are attempting to comply with the tax law, but are having difficulty and require special assistance and consideration in the filing and payment of tax due.
- Will not pay - These are taxpayers who are not complying with the tax law and require appropriate enforcement actions to file and pay the tax due.

Modern tax organizations have also recognized that taxpayer needs vary by category of taxpayer. For example, categories having unique needs could include sole traders; partnerships; small companies; medium-size enterprises and large businesses.

To ensure all taxpayer needs and requirements are met, taxpayer services is responsible for providing quality products and services for all taxpayers by promoting fair, consistent treatment throughout the State or Country.

Examples of products and services typically provided include:

- Simplified forms and instructions;
- Pamphlets and other literature;
4.1. Modern Taxpayer Services Strategies

Taxpayer services strategies need to be specific to the taxpayers of a specific state or territory. However some guidance in developing those strategies can be gained from reviewing international experience. Many countries have developed approaches, such as the following, to describe the direction that they are taking to achieve their vision and strategic goals for excellence in taxpayer services.

Understand the needs - Successful taxpayer services organizations solicit and understand the needs and expectations of their taxpayers. This could be done in the following manner:

- Partnerships with the taxpayers,
- Information and feedback meeting with industries,
- Targeted taxpayer group surveys, speaking with taxpayers on a day to day basis, and seeking ways to improve service by asking taxpayers their opinions

Tailor service delivery to taxpayer needs - Effective products and services are tailored to taxpayer needs and expectations, and these are delivered with balance of cost effectiveness and benefit to taxpayers. This could be done by providing information packages, training sessions, use of technology etc. Other forms of service delivery could be based on business cases that consider the outputs and related costs, so that there is a clear understanding of efficiencies and return on investments.

Service quality is essential - Taxpayers contact and seek employees' knowledge, skills and abilities. The quality of their service or support tools is the key to providing excellent service, regardless of the mode of access used. The staff service and information must be timely and correct to assist the taxpayers and meet their needs. Staff members need to be well trained to provide the information and there is a need to understand that staff members are there to assist and help taxpayers.

Use multiple approaches - Taxpayer service organizations use multiple sources of data, especially front line staff, for enhancing service. The most important point of service is the staff member that is speaking with the taxpayer. The second being the information and educational guides and packages that are provided to the taxpayers to assist them in completing their tax returns and understanding the tax laws and their obligations.

Well managed staff members are essential - Satisfied, capable employees are key to achieving a high level of taxpayer satisfaction. There are many elements that create an environment in which Taxpayer Service staff are satisfied and capable. It starts with education, training, appropriate salary levels for work performed, good service products that meet the needs of the taxpayers, the authority to assist the taxpayers within guidelines, and a strong desire to help taxpayers.
Measure performance - Taxpayer service organizations measure service outcomes. There is a need for a strong management information system that sets budgets and goals, measures the work performed and the effectiveness of the operation.
5. VAT Organization Design

Execution of a good tax payer strategy relies heavily on the organisation designed to facilitate it. Organisation design for a VAT administration must:

- Translate tax payer strategy to operational terms
- Align organisation to the taxpayer strategy
- Make tax payer strategy a continual process
- Mobilise the required changes through leadership

In the following sections the various options and guiding principles for design of VAT organization are discussed in detail.

5.1. Organizational structure design considerations

A successful VAT administration requires both an effective field delivery function and excellent guidance and oversight from headquarters. The two levels of administration (field and headquarters) have quite different functions and responsibilities – the field offices being responsible for assessing and collecting tax liabilities, while headquarters is fundamentally a design and oversight body.

More specifically the headquarters role is to:

- Develop national strategic plans which, through specifying the aims, direction and targets of the tax administration, will enable it to maximize revenue collection;
- Allocate the financial and human resources to functions and offices as part of an annual planning and budgeting activity;
- Design, develop and promulgate operational policies and processes for all aspects of the tax administration operation;
- Set performance standards and delivery targets;
- Monitor the performance of the field offices to ensure that national processes are being followed and that targets are achieved. Identify reasons for non achievement or non performance and take remedial action;
- Ensure national consistency of operational delivery;
- Manage national external relationship issues including public relations and media management;
- Ensure the integrity of the organization’s workforce.

A tax administration undergoing significant modernization or re-engineering (for example, the implementation of a VAT) should, ideally, first develop a comprehensive strategic plan to provide assurance that its top management intentions support the government’s aims and to give the fundamental guidance and direction required by managers and staff.

Traditionally the strategic plan would therefore comprise clear statements of
Organizational objectives
Strategic aims
Performance standards and
Values

It would also form the basis of the government’s and departmental priority and resource allocation decision making with respect to tax administration.

Once the direction is finalized and agreed, the next organizational design requirement is to organize staff and other resources in a way which will enable the aims to be achieved. In essence this requires the design of an appropriate organizational structure (for both headquarters and the field) followed by the allocation of staff to the units and the detailed design of their functions.

A well designed structure will contribute to:

- Speedier decision making;
- Better quality of analysis and improved delivery design;
- Improved coordination between activities;
- More accurate and generally higher quality information flows between staff and managers; and
- Increased consistency of delivery and performance monitoring.

Three models and approaches to revenue administration have evolved – organization by:

1. **Type of tax**, which is the oldest and most traditional structure, but one which has been largely abandoned by the more advanced tax administrations over the last 20 years;
2. **Function**, under which like activities are grouped at the policy and operational levels; and
3. **Taxpayer segment**, the most recent development under which staff are grouped according to the type of taxpayer.
Additionally, there are variations and hybrid arrangements that combine the functional and taxpayer segmentation approaches\(^1\). The attributes, benefits and disadvantages of each type of structure follow.

### 5.1.1. Type of tax model

The earliest model employed by tax administrators was based on a ‘type of tax’ criterion with most operational functions undertaken as part of administering a tax. Organizing by tax type is most suited to tax administrations in the early stage of development where the tax system is designed around a single principal revenue source.

There are certain advantages of this model, for example:

- It is simple to understand and apply;
- It provides for clear accountability;
- It enables good control to be exercised by tax type; and
- It permits the development of expertise in specific taxes.

However, it has been found to suffer from many shortcomings:

- It is patently inefficient with its inherent duplication of functions (e.g., information processing, collections) and potential for uncoordinated actions (e.g., audits and collection actions);
- It is inconvenient and burdensome for taxpayers, requiring them to deal with different organizational units on similar issues (e.g., taxpayers’ inquiries, audits, collections);
- Administrative costs are high; and
- It negates the flexible use of, and underutilizes, staff whose skills and experience are generally confined to one tax.

Some of the practical problems arising with this model are described below.

- Uncoordinated audit and collection actions
- Taxpayers are inconvenienced by having to deal with separate departments on similar issues.

\(^1\) The most common hybrid is a functional structure which includes a single customer segment – a large taxpayer unit – which has proved to be a particularly effective approach for a number of countries.
Separate taxpayer registration/numbering systems
Separate information application systems for each tax that “don’t talk to each other” resulting in duplication of data gathering, uncoordinated actions.
Framing of the tax law in a way that leads to inconsistent treatment of taxpayers (e.g. different penalties between taxes for the same offence)
Inconsistent priorities between taxes in administering the tax laws; resource imbalances arise between the different ‘tax type’ operations, and are difficult to correct.
Reduced flexibility in use of staff whose specialist knowledge is generally limited to a single tax (while expecting taxpayers to be fully aware of all their obligations!)

For these sorts of reasons, most countries have abandoned the ‘type of tax’ model for the ‘functional’ model.

5.1.2. The functional model

Under the ‘functional’ model, staff members are organized according to specific functions (e.g. registration, information processing, accounting, audit, enforced collections, disputes) and work across all taxes.

Such an approach to work design permits: (1) greater standardization of identical work processes across taxes; (2) facilitates simplification for taxpayers, reduces taxpayer costs and enhances compliance; and (3) enables greater productivity to be achieved. Standardizing processes across taxes also facilitates their automation.

Compared with the ‘type of tax’ model, the ‘functional’ model offers many potential advantages to taxpayers and also improves the way some compliance/enforcement activities can be undertaken.

Taxpayer Service - A single point of access (i.e. a dedicated taxpayer inquiry service) can be provided for taxpayers, enabling them to readily obtain all information needed to assess tax liabilities/understand obligations.
Registration - A single unified system of registration can be established, thus enabling required taxpayer identification data to be captured only once but used many times.
Accounting - Processes for making tax payments can be unified, and a common accounting framework can be adopted. It becomes possible to provide taxpayers with comprehensive ‘all taxes’ accounting statements.
Refunds - All tax liabilities can be taken into account when processing refund claims.
Tax returns - There is potential to integrate information requirements in tax returns and simplify processing.
Audits - Comprehensive multi-tax audits can be conducted, reducing the frequency of visits to taxpayers, and the associated burden.
Collections - Ability to co-ordinate enforcement activity for all debts of taxpayer.

5.1.3. The taxpayer segment model
A recent trend among a number of more sophisticated national tax authorities (e.g. in Australia, Netherlands, New Zealand, United States) is to organize around segments of taxpayers (for example: large taxpayers, small/medium businesses, non- business individuals).

The rationale for organizing around different segments of taxpayers is that each group of taxpayers has different characteristics and tax compliance behaviours and, as a result, presents different risks to the revenue. In order to manage these risks (i.e. improve voluntary compliance with the law for each specific group of taxpayers), the tax authority needs to tailor and deliver a set of strategies that are appropriate to the unique characteristics and compliance issues presented by each group of taxpayers.

Such strategies can include targeted audit action, law clarification by public rulings, specific taxpayer education initiatives and changes to the law. Proponents of the ‘tax segment’ structure contend that grouping all functional activities within a single and dedicated management structure for each segment of taxpayers increases the prospects of improving overall compliance.

Advantages of this approach include:
- Strengthening of accountability for organizational outcomes;
- Increased ability to allocate resources based on risk assessment;
- Better matching of enforcement, service and educational programs to the type of taxpayer and their needs

Against these advantages, the approach:
- Reintroduces some of the difficulties associated with the duplication of functions,
- Can increase operating costs; and
- Is complex to operate and requires highly skilled management.

Despite the advantages, there is currently a clear trend for countries which have adopted a full segmentation model to reintroduce elements of the functional structure. This appears to have been because of the management complexities and the difficulties of securing high compliance levels with multi-tasked staff rather than compliance specialists.

**5.2. Which organization should administer the VAT?**

Traditionally there are three options which government can consider. These are
- The Customs department,
- The Inland Revenue department or
- Establish a new VAT department

In India, the VAT is administered at the state level by a separate department. Nevertheless, this discussion is important to analyse the components of an ideal administering authority.
The selection between the options will involve a consideration of three basic issues:

- The ease with which the VAT can be integrated with the current departmental responsibilities
- The capacity of each of the existing department to take on a major new responsibility
- The operating costs associated with each option

5.2.1. Customs department

As the table below indicates, few countries have selected the customs department to administer the VAT. The reasons for this are basically that customs almost always has less experience at revenue collection than the Inland Revenue department and that what experience they do have is with taxes or duties where compliance is primarily achieved through physical controls rather than the financial controls required for a VAT.

The most successful example of administration by Customs has been the UK where the responsibility was given to that department because of the impossibility, at that time, of the Income Tax Department taking on an additional major task.
### VAT Administration arrangements

<table>
<thead>
<tr>
<th>Country</th>
<th>Administered by Tax Department</th>
<th>Administered by Customs</th>
<th>Administered by VAT department</th>
</tr>
</thead>
<tbody>
<tr>
<td>European Union</td>
<td>10</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Other European</td>
<td>14</td>
<td></td>
<td>1</td>
</tr>
<tr>
<td>BRO²</td>
<td>15</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Latin America</td>
<td>18</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>Africa</td>
<td>18</td>
<td>1</td>
<td>5</td>
</tr>
<tr>
<td>Asia-Pacific</td>
<td>13</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Middle East</td>
<td>1</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>North America</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>90</strong></td>
<td><strong>4</strong></td>
<td><strong>14</strong></td>
</tr>
</tbody>
</table>

### 5.2.2. Income Tax Department

Generally the administration of the VAT finds a natural home with the department collecting income based taxes because of the similarities of function and the fact that liabilities for both taxes are calculated from the same financial records. VAT taxpayers will generally already be registered with the department and taxpayer agents are familiar with departmental practices. Audit approaches are similar and there is scope for joint investigation where fraud is suspected.

### 5.2.3. A separate VAT department

If there are serious doubts about the capacity of the existing departments to take on the new responsibilities, an option is to create a new department to administer the VAT. Where such a decision is taken it is generally as part of a broader modernization strategy under which the plan is to amalgamate the responsibilities of the weaker revenue agencies with those of the modern VAT department when its own operation has matured sufficiently. This is an inherently more expensive option than using either customs or ITD as it duplicates a number of the management and support functions of the existing department and certain economies of scale are, therefore, denied to government.

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² Baltic States, Russia and other states of the former Soviet Union
6. Performance management in VAT administrations

As discussed in the section on strategic management in VAT administrations, a well-designed and implemented performance management system is essential for a tax administration to be able to monitor its operations in order to: (1) create accountability for results; and (2) to learn from its performance levels so that information can be fed back into strategic decision making.

A good performance measurement system also acts as a motivation and incentive for employees to perform better. A good performance measurement system is strongly tied to the taxpayer service strategy. One of the key benefits of a functional organisation is that it facilitates setting well defined tax payer oriented performance targets beyond simple revenue targets. This leads to greater accountability and improved taxpayer service.

The main features of a performance management system are:

- Formulation of a set of performance measures for each of the tax administration’s programs that include both quantitative and qualitative measures
- Development of a methodology for measuring operational performance, taxpayer satisfaction and tax officer satisfaction
- Creating a set of standards and systems for defining, measuring, and compiling data on each performance measure
- Strengthening the role of headquarters in designing, managing, and ensuring the integrity of the performance measurement system

6.1. Measuring results

Measures of tax administration results are used to assess the organizational effectiveness for all key operational areas such as taxpayer services, audit and enforcement. Effective revenue administrations have all developed performance management systems which aid in assessing the organizations’ performance by reference to a range of deliverables rather than simply focusing on revenue yield. Such measures typically cover quantitative and qualitative factors.

Quantitative measures include the number of actions taken by the agency (e.g., the number of taxpayers served, phone calls answered, letters replied to or audits conducted). They also assess the efficiency of operation by measuring issues such as the number of calls answered per person or the amount of revenue assessed per hour of auditor time.

Qualitative measures assess the extent to which service and enforcement actions delivered meet the required quality standards. They are determined by comparing work performance against preset standards. Additional quality measures will assess accuracy and timeliness.
6.2. Implementation of performance management

The development of a performance measurement system will involve the following basic steps:

- Identify an initial set of measures for each function
- Establish baseline levels so that future performance can be evaluated
- Develop methods for measuring performance
- Analyze and report results for each measure

6.2.1. Step 1 - Identify an initial set of measures for each function

From the existing workload data, procedure sheets, guidelines and practice, identify departmental expectations for how much of each task has to be completed, the time it ought to take and required accuracy of delivery. The table below gives indications of sample measures for some core tax administration tasks.

<table>
<thead>
<tr>
<th>Function</th>
<th>Examples of Primary Work Product Outputs (Quantity)</th>
<th>Examples of Measures of Quality</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxpayer Service</td>
<td>1. Total Number of Taxpayers Assisted</td>
<td>1. Average taxpayer wait time for service</td>
</tr>
<tr>
<td></td>
<td>2. Number of taxpayer calls answered</td>
<td>2. Average time to respond to taxpayer requests</td>
</tr>
<tr>
<td></td>
<td>3. Number of walk-in taxpayers assisted</td>
<td>3. Accuracy of responses provided (measured by review)</td>
</tr>
<tr>
<td></td>
<td>4. Number of correspondence answered</td>
<td></td>
</tr>
<tr>
<td></td>
<td>5. Number of e-mail requests answered</td>
<td></td>
</tr>
<tr>
<td></td>
<td>6. Number of accesses to tax agency internet site</td>
<td></td>
</tr>
<tr>
<td></td>
<td>7. Number of tax guidance requests completed</td>
<td></td>
</tr>
<tr>
<td></td>
<td>8. Number of advisory/registration validation visits</td>
<td></td>
</tr>
<tr>
<td></td>
<td>9. Number of registrations recorded</td>
<td></td>
</tr>
<tr>
<td>Returns Processing</td>
<td>1. Number of Returns Processed</td>
<td>1. Average processing time</td>
</tr>
<tr>
<td></td>
<td>2. Number of Refunds Issued</td>
<td>2. Return processing accuracy/error rate</td>
</tr>
<tr>
<td></td>
<td>3. Number of Notices Issued</td>
<td>3. Payment processing accuracy/error rate</td>
</tr>
<tr>
<td></td>
<td>4. Percentage of Returns Filed Electronically</td>
<td></td>
</tr>
<tr>
<td></td>
<td>5. Percentage of Returns Filed by Paper</td>
<td></td>
</tr>
<tr>
<td></td>
<td>6. Number of Payments Processed</td>
<td></td>
</tr>
<tr>
<td></td>
<td>7. Total Value of Payments Processed</td>
<td></td>
</tr>
<tr>
<td>Function</td>
<td>Examples of Primary Work Product Outputs (Quantity)</td>
<td>Examples of Measures of Quality</td>
</tr>
<tr>
<td>------------</td>
<td>----------------------------------------------------------------------------------------------------------------------</td>
<td>--------------------------------------------------------------------------------------------------</td>
</tr>
</tbody>
</table>
| VAT refunds| 1. Number of claims received  
2. Value of claims received  
3. Number of claims approved  
4. Value of claims approved  
5. Data on claims allowed/disallowed                                                                 | 1. Average time to release refund  
2. Unresolved claims after 30 days                                                              |
| Audit      | 1. Number of Audits Completed  
2. Number of Simple Audits  
3. Number of Comprehensive Audits  
4. Number of refund verifications                                                                 | 1. Time spent each audit  
2. Average length of audit  
3. Audit quality  
4. Tax assessed                                                                                   |
| Collections| 1. Total Value of Arrears Collected  
2. Total Number of Collection Cases Closed  
3. Total Number of Taxpayers Contacted                                                                 | 1. Average age of collection cases  
2. Percentage of cases resolved within X months  
3. Collection case quality score                                                                   |
| Appeals    | Total Number of Appeals Cases Closed                                                                                   | 1. Average length of appeals case  
2. Appeals case quality score                                                                         |

6.2.2. Step 2 - Establish baseline performance levels.

Until baseline performance levels are established it will not be possible to set future standards or to assess whether standards have been achieved and if so to what degree. If existing data is adequate, it will be possible to set baselines and standards at the inception. However, in some cases, the data may not have been kept for earlier periods and it will therefore be necessary to establish baselines (and then standards) from initial performance measurement.

For example, it can be assumed that simple quantity measures will already exist for many core activities (such as the number of VAT audits to be conducted and the number of returns to be processed). However, it is unlikely that there will be sufficient data to enable standards and targets to be set, initially, for issues such as the standard time required completing a complex audit.
6.2.3. **Step 3 - Develop methods for measuring performance.**

Some measures (such as simple quantities and timeliness) can be easily measured as by-products of processing. For example, data on the number of returns received and numbers of payments processed will be easily captured from the IT system and data processing reporting. Timeliness data is probably not currently recorded, but can be easily measured if a proper time recording system is introduced.

Pure quality measures are not easily measured as they require the work performed by staff to be independently verified. Quality can be assessed by conducting formal quality reviews of randomly selected samples of work.

6.2.4. **Step 4 - Analyze and report results.**

Headquarters staff should prepare regular performance reports for all managers, analyzed by geographic area and functional unit. The reports should, for each target, provide information on the target, performance to date, past performance and comment on any major factors influencing the achievement.

The development of a performance management system will be resource intensive – both during the inception phase, and to a lesser extent, during ongoing operation. The initial measurement systems development and the ongoing task of analyzing and reporting at the national level would be an appropriate task for a strategic planning unit.

6.3. **Commissioner overview**

While the Commissioner should receive a comprehensive monthly performance evaluation report on all aspect of the organizations performance, there may be a need for a supplementary and simpler set of high level indicators to highlight immediate conditions.

Some tax administrations have therefore developed a system which continually (or every few days) extracts a few highly significant indicators (covering all key areas) from the full set and presents both the current position and time based trends in an easily understood manner. The subset of measures likely to most accurately indicate the overall health of the administration would inevitably emerge over time, however an initial set could include the following:
For effective performance and efficient delivery of taxpayer services, especially in a functional organisation, it is pertinent to have well defined processes which the personnel can efficiently execute. The VAT business processes must be robust enough to handle exceptions and should clearly define the steps to be taken by the tax officer in such exceptional situations. Well defined processes also improve the transparency of the VAT administration.

The following chapter discusses the leading practices internationally with respect to VAT business processes.
7. VAT Business Processes

7.1. The key VAT operational tasks

Prior to a discussion on VAT business processes, it is essential to prepare a universe of tasks that a revenue administration needs to perform and subsequently demarcate the key business processes of a VAT administration. The table below outlines the various processes involved in a general revenue administration:

<table>
<thead>
<tr>
<th>Technical Tasks of a Revenue Administration (RA)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Registration</strong></td>
</tr>
<tr>
<td>§ Registration of taxpayers;</td>
</tr>
<tr>
<td>§ Registration of importers, exporters, brokers, clearing agents etc.;</td>
</tr>
<tr>
<td>§ Assignment of unique taxpayer identification numbers (TIN); Periodic updating of taxpayers’ registers;</td>
</tr>
<tr>
<td>§ Detection of unregistered potential taxpayers.</td>
</tr>
<tr>
<td><strong>Taxpayer Services</strong></td>
</tr>
<tr>
<td>§ Taxpayer education: Seminars, workshops, advertisements, brochures, TV ads, interviews, competitions; books for adolescents, dissemination through the internet etc.</td>
</tr>
<tr>
<td>§ Taxpayer assistance: Telephone Help lines; Floor walkers; Assistance in understanding legal and procedural issues and filling forms.</td>
</tr>
<tr>
<td>§ Facilitation of voluntary compliance:</td>
</tr>
<tr>
<td>o Setting up of one stop offices and counters;</td>
</tr>
<tr>
<td>o Providing electronic filing and payment facilities;</td>
</tr>
<tr>
<td>o Refurbishing waiting areas</td>
</tr>
<tr>
<td><strong>Trade Facilitation</strong></td>
</tr>
<tr>
<td>§ Improving cargo and passenger processing procedures;</td>
</tr>
<tr>
<td>§ Reducing clearing time;</td>
</tr>
<tr>
<td>§ Enabling electronic filing of customs declarations, payment of duties and clearance of goods;</td>
</tr>
<tr>
<td>§ Creating fast track processes for established, compliant clients;</td>
</tr>
<tr>
<td>§ Establishing joint border posts;</td>
</tr>
<tr>
<td><strong>Processing of Returns and</strong></td>
</tr>
<tr>
<td>§ Receipt and checking of tax returns;</td>
</tr>
</tbody>
</table>
### Technical Tasks of a Revenue Administration (RA)

<table>
<thead>
<tr>
<th>Payments</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>§ Receipt and checking of customs declarations and valuation, classification of imports and exports;</td>
<td>§ Processing of payments of taxes and duties;</td>
</tr>
<tr>
<td>§ Detection of non-filers, stop-filers and payment defaulters;</td>
<td>§ Remedial actions to secure compliance with filing and payment obligations;</td>
</tr>
<tr>
<td>§ Issue of tax refunds.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Monitoring of tax withholders and collection agents</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>§ Monitoring of persons required to withhold tax on payments made to other taxpayers to verify:</td>
<td>§ Monitoring of Banks and other organizations receiving tax returns and payments to verify:</td>
</tr>
<tr>
<td>o Whether the correct amount of tax is withheld;</td>
<td>o Timely payment of taxes into government account;</td>
</tr>
<tr>
<td>o The amount of tax withheld is paid to the RA in time.</td>
<td>o Quality of transcribed information forwarded to the RA</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Collection of information about taxable transactions</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>§ Collection of information from third parties:</td>
<td>§ Intelligence operations</td>
</tr>
<tr>
<td>o Financial institutions</td>
<td></td>
</tr>
<tr>
<td>o Govt. Agencies</td>
<td>§ Purchase of information from informants;</td>
</tr>
<tr>
<td>o Traders</td>
<td>§ Processing of complaints of tax evasion;</td>
</tr>
<tr>
<td>o Foreign Government</td>
<td>§ Surveillance of suspect taxpayers;</td>
</tr>
<tr>
<td>o Stock brokers</td>
<td>§ Research and analysis.</td>
</tr>
<tr>
<td>§ Search and seizure, and survey operations to obtain incriminating evidence.</td>
<td></td>
</tr>
<tr>
<td>Technical Tasks of a Revenue Administration (RA)</td>
<td></td>
</tr>
<tr>
<td>---------------------------------------------------------------------</td>
<td></td>
</tr>
<tr>
<td><strong>Risk analysis and selection of cases for physical inspection, audit and investigation</strong></td>
<td></td>
</tr>
<tr>
<td>- Physical inspection of cargo, passenger baggage, ships, aircraft and vehicles</td>
<td></td>
</tr>
<tr>
<td>- Physical inspection to detect undeclared imports and exports</td>
<td></td>
</tr>
<tr>
<td>- Analysis of returns and declarations, in the light of risk factors, to select cases where the possibility for tax fraud is high.</td>
<td></td>
</tr>
<tr>
<td>- Apprehend contraband</td>
<td></td>
</tr>
<tr>
<td><strong>Audit and Investigation</strong></td>
<td></td>
</tr>
<tr>
<td>- Audit planning</td>
<td></td>
</tr>
<tr>
<td>- Examination of returns and books of accounts</td>
<td></td>
</tr>
<tr>
<td>- Inquiries from third parties</td>
<td></td>
</tr>
<tr>
<td>- Collection of documentary and oral evidence</td>
<td></td>
</tr>
<tr>
<td>- Examination of legal issues</td>
<td></td>
</tr>
<tr>
<td>- Assessment of additional liabilities for tax, interest and penalties</td>
<td></td>
</tr>
<tr>
<td>- Evaluation of audits</td>
<td></td>
</tr>
<tr>
<td><strong>Recovery of Tax Arrears</strong></td>
<td></td>
</tr>
<tr>
<td>- Persuasive recovery</td>
<td></td>
</tr>
<tr>
<td>- Coercive recovery</td>
<td></td>
</tr>
<tr>
<td>- Bankruptcy proceedings</td>
<td></td>
</tr>
<tr>
<td>- Recovery through courts.</td>
<td></td>
</tr>
<tr>
<td><strong>Anti-smuggling operations</strong></td>
<td></td>
</tr>
<tr>
<td>- Search and seizure operations;</td>
<td></td>
</tr>
<tr>
<td>- Checking of vehicles in transit;</td>
<td></td>
</tr>
<tr>
<td>- Apprehension of contraband;</td>
<td></td>
</tr>
<tr>
<td>- Sale or destruction of confiscated goods.</td>
<td></td>
</tr>
<tr>
<td><strong>Monitoring and control of bonded warehouses</strong></td>
<td></td>
</tr>
<tr>
<td>- Checking warehouses to ensure compliance with contractual obligations;</td>
<td></td>
</tr>
<tr>
<td>- Verification of internal controls;</td>
<td></td>
</tr>
<tr>
<td>- Periodic verification of inventories.</td>
<td></td>
</tr>
</tbody>
</table>
As discussed earlier, in the context of a VAT administration, compliance checks require verification of financial flows and information and not physical movement of goods. Liabilities for VAT are calculated by reference to record of financial transactions and commercial documentation.

Only during specific audits of VAT cases the financial checks need to be backed up by physical checks of the assets (e.g. refund verification). This implies that many of the tasks listed in the table above pertaining to physical checks of assets are not required to be performed by a VAT administration.

Also, there are four gaps which a good VAT administration must close and these in turn determine the criticality of the business processes. These four gaps are:
1. Unregistered taxpayers: Taxpayers must be required to register. Whether compulsory or voluntarily, registration must be made easy, and an appropriate single taxpayer identification number (TIN) must be issued. The system must be able to identify those who do not voluntarily register.

2. Stop filers: Tax liability must be determined. This may be done administratively (as with most property tax) or through self-assessment procedures, as with most income taxes and VAT.

3. Delinquents: The taxes due must be collected. In many countries this is done through the banking system.

4. Evaders: A proper system (tax audit) must be set up to deal with those who are in the system but are substantially under-reporting.

Keeping this aspect in mind and also the relevance to the processes selected under the Commercial Taxes Mission Mode Program, the following sections will discuss leading practices with respect to the following major VAT processes:

1. Registration
2. Returns, tax payment and penalties
3. Refunds

### 7.2. Registration

VAT requires a dynamic approach to new taxpayer registration. This flows from a number of features of the VAT, for example:

- The pace with which arrears can accumulate if businesses are not registered immediately they commence;
- The requirement for taxpayers to issue valid invoices to their customers from the day of commencement; and
- The compliance risks associated with false registration.

The key requirements of the registration system are:

- On commencement of the VAT to ensure that all existing businesses with turnover above the threshold are registered automatically
- To ensure that new businesses operating above the threshold are identified quickly by the VAT office – the most effective administrations have put in place systems to ensure automatic registration where a new business is registered with an organization such as the companies office, business registration department etc.
- Identify potential false registrations which are likely to be a precursor to attempted VAT fraud.

Efforts should be made to keep the registration process user friendly like having a single page registration form and doing away with all the unnecessary information requirements. The registration process will generally include functions such as: the automated allocation of a taxpayer identification number, issue of a VAT certificate, issue of initial blank return and will also trigger a taxpayer service advisory contact.
7.2.1. Identification of potential but unregistered dealers

Identification of potential but unregistered dealers is usually done in a two-fold manner:

1. Audit of registered taxpayers: The first approach is to audit registered taxpayers in order to detect their unregistered suppliers or customers. If VAT is in place, this may be done by checking that purchases invoices on which VAT credits are claimed and sales invoices show a valid TIN; detection of an invalid TIN may lead to the detection of unregistered taxpayers.

2. Locality inspections: The second approach involves searches or inspections in which a group of officials go door-to-door within a particular geographical area, checking that all persons or establishments engaged in taxable business activity in that area are properly registered.

7.2.2. Determining a VAT registration threshold

One of the common problems faced by VAT administrations is the over-registration of taxpayers with only a small percentage of the registered taxpayers actually filing returns and paying taxes. This makes it more difficult to identify and monitor taxpayers who contribute significant amount of revenue and creates an unproductive workload for the tax administration. This makes it essential to set a reasonable registration threshold keeping in view the administrative capacity of the department.

7.2.3. Taxpayer Identification Number

The Taxpayer Identification Number (TIN) has four main objectives:

1. To facilitate computer applications, such as detecting taxpayers who fail to submit returns (stop filers) and taxpayers who fail to pay on time their tax liability (delinquent accounts);

2. To help cross-check information on taxpayer compliance, such as selective cross-checking of sales and purchases among sales tax taxpayers or amount of imports through customs versus sales and purchases reported on sales tax and income tax returns;

3. To establish communication and transfer of information between the customs and tax administrations; and

4. To be used for statistical purposes/business register, surveys of businesses, and data for other parts of government.

Ideally, each business entity must have only one TIN and it must be centrally allocated to ensure that duplicate TIN is not issued. Following are examples from Canada on the format of TIN adopted.

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Format of Canadian Business Number
In Canada, the following system is used for issuance of the Business Number. The BN is a unique federal government numbering system that identifies business and the various accounts maintained by it. This 15-digit number consists of:

- A 9-digit registration number that identifies the business
- 2 letters for the type of account
- 4 numbers for the specific account reference

In this example, "Company X" wants to register with the CRA for a Business Number, one GST/HST account, and a payroll account. The company will receive:

- Registration number - 123456789
- GST/HST account - 12345 6789 RT 0001
- Payroll account - 12345 6789 RP 0001

To produce a reliable input, TIN should be self-checking, i.e. it should have a check digit. The purpose of a check digit is to check errors, for example, the transposition of numbers when a TIN is written in a document or transmitted into magnetic media.

7.2.4. Economic Activity Code

To produce statistical information for analyzing the performance of the tax system and for better auditing, each taxpayer should have an economic activity code which should get recorded in the taxpayer identification master file. At the time of registration the taxpayer should assign the code to himself using the tax administration’s economic activity code table; the code of a large taxpayer should be reviewed at the advisory visit since an incorrect use of the code by a large taxpayer could cause serious statistical distortions.

It is advisable to follow the structure of the International Standard Industrial Classification (ISIC) code for economic activity code. The ISIC uses only numbers and the numbers used are arranged according to a decimal system.

7.2.5. Online registration

Most countries provide Business Registration On-line as a one stop, online, self serve application that allows taxpayers to register for a new Business Number which would be used across all tax programs including Income Tax, Goods and Services Tax, Payroll Deductions, and Import / Export accounts.

7.2.6. Online search of business TIN
Internationally, TIN information is maintained as a public register and the following information is made available to the public for open querying.

- Business Number TIN;
- Business Number TIN status (date of effect of registration);
- Legal name;
- Entity type (such as company, sole trader, trust or superannuation fund);
- Trading name (trading or business name);
- State (from the address provided as main business address);
- Postcode (from the address provided as main business address);
- Goods and Services Tax (GST) registration (status and date of effect);
- Deductible gift recipient status and date(s) of effect (if applicable);
- Tax concession charity status and date(s) of effect (if applicable);
- Income tax exempt fund status and date of effect (if applicable);
- The date of a TIN change - if the Registrar has changed the entity's TIN;
- The date of TIN cancellation - if the Registrar has cancelled the entity's registration in the Business Register.

This information will allow members of the public to verify the details of the registered business entity they are dealing with.

7.2.7. **Benchmark performance measures for registration**

Following are the international benchmarks for registration of new businesses:

- After initial implementation, all TIN to be issued within three (3) working days of the receipt of registration application.
- TIN should be issued immediately for large business taxpayers provided all relevant documentation is provided with the application.
- Ratio of active (operating regularly) to total registered taxpayers > 90%
- Ratio of taxpayers with more than one TIN to total registered taxpayers < 5%

7.3. **Return, tax payment and penalties**

7.3.1. **Management of return processing**

Managing return filing can be seen as being an extension of the registration system in that any registered taxpayer failing to file a return by the due date will be followed up promptly with an automated reminder notice and the automatic imposition of appropriate penalties. Monitoring and suo moto initiation of de-registration procedures are usually a fall-out of the returns process.
As far as possible, VAT taxpayers should be required to file their returns electronically. Countries with established VAT systems are moving taxpayers to electronic filing as quickly as they can and countries currently considering the introduction of the tax (for example the territory of Hong Kong) are considering making electronic filing mandatory.

Comprehensive strategies would be required to encourage taxpayers to file electronically such as accelerating the issuance of refunds, extending the filing dates (possibly), free-use of filing software, on-line help facility, and mailing out promotional materials. The recent experience of the United States, as summarized in the following box, is particularly instructive of the good results that can be achieved through concerted action.

**Promoting Electronic Filing: The Experience of the United States Internal Revenue Service**

<table>
<thead>
<tr>
<th>The number of individual tax returns filed electronically grew from about 40.2 million in 2001 to about 46.9 million in 2002—as increase of about 16.5 percent—and the percentage of individual tax returns filed electronically reached 35.9 percent.</th>
</tr>
</thead>
</table>

Over the years, IRS has identified many impediments to electronic filing, including privacy and security concerns, cost, lack of awareness of or interest in electronic filing, an inability to file all forms and scheduled electronically, and a need to send certain paper documents to IRS even if the return was filed electronically. In 2002, the IRS took numerous steps to alleviate these impediments and thus encourage more electronic filing that included the following:

**Increase in the electronic filing marketing budget** from $9 million in 2001 to about $15 million in 2002 and focusing the marketing campaign on taxpayers and practitioners who filed computer-prepared returns on paper.

**Mailing a postcard to about 23 million taxpayers**, including about 8 million taxpayers who had prepared their return on a computer but filed on paper, informing them of the benefits of electronic filing and the self-select personal identification number (PIN) program. The postcard also informed them that professional tax return practitioner could be used to file their returns electronically and explained how the self-select PIN can be used to sign returns filed through a tax practitioner.

**Mailing two different letters to tax practitioners**. The first letter was sent to practitioners who were already participating in the electronic filing program to thank them for participating and encourage them to continue to support the program. The second letter was sent to practitioners who were not participating in the electronic filing program and told them about the benefits of electronic filing; changes that had been made for the program, and pending changes. IRS enclosed a document with both letters that provided more information on the benefits of electronic filing and the self-select PIN program. In total, about 250,000
Promoting Electronic Filing: The Experience of the United States Internal Revenue Service

letters were sent to practitioners.

Reinstating the practitioner PIN program. In 2001, practitioners informed IRS that they liked the practitioner PIN program, which IRS had terminated in favour of the self-select PIN program, and would like to see it reinstated. As of October 25, 2002, 83.9 percent of tax returns prepared by tax practitioners and signed by a PIN were signed through the practitioner PIN program. The other 16.1 percent were signed using a self-select PIN.

Changing the self-select PIN program at the request of tax practitioners. In 2002, taxpayers entered only their adjusted gross income from the prior tax year to verify their identity. In 2001, taxpayers had to enter not only their adjusted gross income but also their total tax to verify their identity. Tax practitioners wanted the number of items used to verify identity reduced—known as “shared secrets”—reduced from two to one, because errors related to shared secrets resulted in numerous electronic returns being rejected. Consistent with the reduction in the number of shared secrets from two to one, the number of reject conditions on electronic tax returns as a result of shared secrets went down from 2.1 million in 2001 to about 1.3 million in 2002.

Making 30 additional forms and schedules eligible to be filed electronically, thereby enabling, according to the IRS, 99 percent of all individual forms and scheduled to be filed electronically.

In 2003, the IRS achieved a take-up rate for individual returns of around 40 percent—an increase of about 11 percent over 2002. For 2004, the take-up rate for e-filed returns (as of September 2004) was 47 percent, reflecting further significant gains in the success of the IRS’s e-filing services. (Source: US General Accounting Office)

7.3.2. Tax return forms

Return forms are used to request data from taxpayers. However, if the authorities cannot make use of the data promptly, the requests merely slow down the tax collection process. It is found that simply being asked to supply information is not intimidating to taxpayers. Effective enforcement is the only way to improve voluntary compliance.

In the case of VAT, the administration’s ability to convert data promptly into usable information is basic; after a period of time the information collected becomes useless. Therefore, it is pointless to ask taxpayers to give full details about sales and purchases because it would be impossible to process such information accurately within a reasonable time frame.
An ideal return form is a combined tax return and payment form. Therefore, no special receipt should be issued when the return is submitted; the stamp on the copy of the return which the taxpayer keeps should be the only receipt needed.

Only one return, consolidating sales and purchases of head office and branches, should be permitted for each registered taxpayer. The head office and the branches should be treated as one taxable entity.

7.3.3. **Filing of return and payment of tax**

Internationally, using banks to collect VAT has been generally successful since they are used to receiving payments and handling money. Collection through banks is a sort of privatization of tax collection. Countries which have successfully implemented this model are Argentina, Brazil, Italy, Japan, Mexico, Portugal and Spain.

As regards fees paid to banks for collecting taxes, four alternative methods are being used in different countries:

- A fixed amount of money is paid to for each return or payment received regardless of the amount of tax collected
- A percentage of the tax collected is paid regardless of how many tax returns or payment receipts were received
- Banks keep collections for a certain period before transferring them to the treasury (the problem with this method is that the remuneration varies with the interest rate; for a given period higher the real interest the greater the remuneration)

7.3.4. **Penalties**

Internationally, the structure, severity and coverage, of penalties increases with: (1) the potential revenue loss due to the tax offence; (2) the difficulty and cost of detecting the offence; (3) the effect of the offence on other taxpayers; (4) the offender's state of mind (a higher penalty should apply if the offence is deliberate and pre-planned; and (5) recidivism.

Penalties for non-compliance are inversely related to the ease of compliance. It appears reasonable to levy the highest penalties for the failure to register as a taxpayer, or the failure to file a return on time, and the lowest for failure to pay tax due, in order to tilt taxpayer non-compliance actions to the last stage. An illustration of this principle is shown below based upon the Japanese National Tax Agency Report.
### System of penalties in Japan

<table>
<thead>
<tr>
<th>Tax return or payment filed/paid by due date?</th>
<th>Regular case</th>
<th>Case of fraud</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return is not filed by due date</td>
<td>Penalty for failure to file - 15%</td>
<td>Fraud penalty - 40%</td>
</tr>
<tr>
<td>Return is filed by due date and tax is paid within two months after the due date</td>
<td>Interest rate of 4.1%</td>
<td></td>
</tr>
<tr>
<td>Return is filed by due date but tax is not paid until two months after the due date</td>
<td>Annual interest rate of 14.6%</td>
<td></td>
</tr>
<tr>
<td>Return is filed by due date but tax amount is understated</td>
<td>Penalty for understatement 10% or 15%</td>
<td>Fraud penalty 35%</td>
</tr>
</tbody>
</table>

#### 7.4. VAT Refunds

(This section on VAT refunds has been extracted from the IMF paper on refunds. To allow for a reader-friendly presentation, explicit quotation marks have not been provided.)

Experience with VAT implementation in many countries shows that refund of credits has been the “Achilles heel” of the VAT. It has been a source of tension between tax authorities and the business sector and, in some countries, has led to complex administrative measures that have significantly undermined the functioning of the VAT system.

A key feature of the invoice-credit form of VAT is that some businesses will pay more VAT on their purchases than they collect on the taxable sales they make, and so should be able to reclaim the difference from the tax authorities. This is particularly true of exporters whose export sales are zero-rated. It is also true of businesses—particularly new enterprises—that make large purchases relative to current sales. Refunds can be substantial. In many countries, VAT refund levels exceed 40 percent of gross VAT collections. Countries with refund levels below 20 percent are mostly in Africa, Asia, and Latin America.

In theory, VAT refunds should be paid promptly following receipt by the tax authority of a VAT return giving rise to an excess credit. That is the practice of most developed countries, where refunds are generally paid within four weeks of a refund claim being made. The situation is different in developing and transitional countries, however, where it often takes several months, and sometimes more than a year, to process refund
claims. In export-oriented countries, such practices can seriously undermine the competitiveness of the export sector.

The prevalence of fraudulent claims is often cited by tax officials as a major reason for delaying payment of refunds. Often, less advanced tax administrations pursue time consuming and labor-intensive processes to verify claims before approving refunds, resulting in backlogs of refund requests and considerable disquiet among business taxpayers who have been deprived of their working capital. In contrast, the most effective and efficient tax administrations tackle refund-related fraud as part of a broader VAT compliance strategy based on risk management principles, and generally limit pre-refund verification checks to perceived high-risk claims.

Delays in processing refunds also occur when state budgets are under pressure, and when tax collection targets are not being met. This often happens when tax authorities and finance ministries do not have suitable forecasting and monitoring systems in place to anticipate refund levels, and do not set aside sufficient funds to meet legitimate refund claims when they occur. Administrations with more sophisticated forecasting and budgeting capabilities have been able to predict refund levels with a fair degree of precision, given that a pattern of refund claims tends to develop within countries over time.

7.4.1. Timeframes for VAT refunds

When tax authorities deny payment of legitimate refund claims, the nature of the VAT is effectively altered, in part, from a tax on final consumption to a tax on production. To avoid this happening, VAT policymakers often advocate that the same tight statutory timetables imposed on persons paying VAT should also apply to tax authorities in refunding VAT. It is of little surprise, therefore, that 90 percent of the countries that responded to an IMF survey on refunds reported that their tax authorities are bound by law to making refunds within a prescribed timeframe, generally 30 days.

Most countries (around 40 percent of those surveyed in the IMF survey on VAT refunds) go further, with their laws providing for interest to be paid on late refunds—this recognizes that excess credits not returned promptly to the taxpayer are tantamount to funds loaned to the government. At the same time, policymakers acknowledge that safeguards need to be in place to tackle fraudsters who take advantage of regimes providing prompt VAT refunds. Safeguards range from providing tax officials with statutory powers to conduct audits and verification checks, to measures such as requiring security or bank guarantees from traders who seek refunds. In 60 percent of the surveyed countries, mandatory carry-forward periods for excess VAT credits are also imposed, generally for non-exporters, to limit the number of refund claims.

7.4.2. Suggested model of best practice (Source: IMF)

Successful tax administrations have found that the most efficient and effective VAT refund processing systems are those that
Distinguish between refund claimants with a history of compliance and those claimants with poor or unknown compliance histories (this entails maintaining historical profiles for each refund claimant);

Use pre-refund audits for high-risk refund claims and post-refund audits for claims of lesser perceived risk; and

Apply criteria to determine the likely extent of revenue risk associated with each refund claim

Against this background, some desirable features of an effective VAT refund system—that are particularly suitable for developing and transitional countries—are outlined below.

1. The number of VAT payers should be kept at a level that can be realistically managed by the tax administration. A high VAT registration threshold should be maintained until the tax authority is sufficiently developed to administer a larger number of VAT payers and refund claimants in a self-assessment environment.

2. VAT registration applications should be subject to proof of identity and other basic checks designed to prevent fictitious traders from entering the VAT system and stealing from the government through the refund system.

3. Suitable forecasting and monitoring systems should be established to anticipate refund levels and make sufficient funds available to meet all legitimate refund claims when they occur. Given that a pattern of refund claims tends to develop within countries over time, authorities should be able to predict, with some degree of certainty, the level of refunds they might reasonably expect to pay throughout the year.

4. Refunds should be processed (i.e., paid, offset, or denied) within a reasonable statutory period (e.g., 30 days of the date on which a refund claim is made). The statutory deadline may be extended in special circumstances, where (1) a filed VAT return is incomplete; (2) the taxpayer has outstanding tax returns; (3) the taxpayer has failed to respond within a reasonable period to verification enquiries; or (4) the tax authority suspects, on reasonable grounds, that the VAT return is inaccurate and/or the taxpayer is engaged in fraudulent activity, in which case the taxpayer should be subjected to audit and/or investigations. The tax administration should report publicly on its performance in meeting the statutory deadline for processing refunds.

5. Interest should be paid on late refunds to compensate taxpayers with legitimate refund claims for being deprived of their working capital.

6. Excess VAT credits should be offset against VAT and other tax arrears, except where an outstanding amount is subject to a genuine dispute. To support this, the necessary taxpayer accounting and debt management systems need to be in place.
7. Immediate refunds of excess VAT credits should always be paid promptly to exporters or to enterprises that export a large share of their products (e.g., where at least 50 percent of the turnover is attributed to export sales). As appropriate, other taxpayers may be required to carry-forward their excess credits for six months. If at the end of this period an amount of excess credit remains, that amount should be refunded to the taxpayer.

8. Verification of VAT refund claims should be a component of a wider audit program aimed at achieving broad coverage of taxpayers and compliance issues. Pre-refund audits should be limited to high-risk cases only (e.g., the first refund claim by a new registrant), while lower-risk claims should be subjected to selective post-refund audits.

9. Preferential treatment should be given to regular exporters with sound compliance histories. Some tax administrations assign an approved refund level within their computer systems for taxpayers with sound compliance records and accounting practices. Others categorize refund claimants according to their compliance history and perceived level of risk. Low risk claimants receive automatic refunds, often within a few days of filing their claims. Selected higher risk taxpayers are required to substantiate their claims.

10. Appropriate sanctions should be consistently applied to taxpayers who falsely claim refunds, or do not comply with record-keeping requirements. Refund-related fraud should be prosecuted through the criminal justice system.

11. Taxpayers should be entitled to appeal, on reasonable grounds, a decision by the tax administration to withhold a refund. Such appeals should be considered by an independent tribunal and dealt with promptly.

12. The tax administration should provide clear information to taxpayers explaining their rights and obligations, and the procedures for making a refund claim. VAT returns and refund claim forms should be simple, have clear instructions, and be filed through means convenient to taxpayers.

7.4.3. Types of VAT fraud and evasion
Based on international experience, IMF has identified the following major types of VAT fraud and evasion.

- Inflated refund claims: The simplest method is to create fake invoices for purchases never made. Indeed, organized crime networks have been known to establish businesses solely to fabricate invoices for sale to those wishing to defraud the revenue.

- Underreported sales: This is the most usual way of evading VAT. Evasion by small operators is common, particularly in retail services where taxable inputs are small relative to taxable sales. By
concealing sales to the domestic market, traders may not only evade their own obligation to charge VAT on their output, but, also, generate excess credits to be refunded.

β Fictitious traders: This involves creation of short-lived sham enterprises that register for VAT and create the illusion of trading in goods and services. A common ploy is to invent fake export invoices on nonexistent goods and claim VAT refunds.

β Domestic sales disguised as exports: Under this scheme, traders sell goods on the domestic market but claim a refund using a fake export invoice.

β Missing trader intra-EU fraud: Typically, a fraudster registers for VAT in an EU country (e.g., the United Kingdom), purchases goods VAT-free from another EU member state, sells those goods at VAT-inclusive prices for home market consumption (in the United Kingdom), and then ceases operations after a period of intense trading and disappears without paying the VAT due.

β A more common and lucrative variant is carousel fraud where, instead of being sold for consumption on the (U.K.) home market, goods are sold through a series of contrived transactions before being sold to a trader in another EU member state, who then sells the goods back to the United Kingdom. This allows the fraudsters to carry out the fraud repeatedly using the same goods.

Other forms of evasion and fraud include:

β Traders that are liable to VAT but do not register;
β Credit claimed for taxable supplies used in exempt activities, and credit claimed on private purchases;
β Credit claimed for invoices from unregistered suppliers;
β Goods imported illegally, and then sold with VAT added but not remitted to the tax authorities; and
β Barter arrangements hidden from the authorities.

Various countries have implemented different methods for checking these frauds and methods of evasion which are discussed in the subsequent sections of this chapter.

7.4.4. Zero rating supplies to exporters

When France adopted the first VAT-type tax with an invoice-based credit mechanism in 1948, a specific scheme (Le système des achats en franchises) was implemented to allow regular exporters to purchase their business inputs free of tax. The aim of the scheme, which in effect applied a zero-rate to supplies made to exporters, was to eliminate the need for exporters to claim refunds of excess credits. The scheme was further developed in 1954 and 1968, when the structure of the tax was improved to become a modern VAT (including broadening the base and extending the VAT credit mechanism).
When the VAT was introduced in other European member states in the 1970s, some of them (e.g., Ireland, Italy, and the Netherlands) adopted the zero-rating scheme for their exporters, although the Netherlands later abandoned it in the 1990s. While the Sixth Directive provides EU member states with the option of adopting this system, only a limited number have done so. In the 1980s, the scheme was introduced in several former French colonies (including Algeria, Côte d’Ivoire, Morocco, Tunisia, and Senegal), and in the 1990s in a few transition and emerging market countries (e.g., Korea, Albania, and Azerbaijan).

Although the scheme may have facilitated introduction of the VAT in France in the early 1950s, it has since been shown to add complexity and revenue risks to VAT administration, largely because the scheme breaks the VAT credit chain. Zero-rating supplies to exporters effectively shifts the problem of controlling refund claims away from a small number of well-known exporters to an often larger and lesser-known group of suppliers.

7.4.5. Invoice matching – Pakistan, Korea and China

Attracted by the theoretical possibility that a tax administration should be able to crosscheck all purchases and sales invoices to validate VAT credit claims (as well as identify undisclosed sales), a few countries have attempted computerized cross-checking of invoices on a grand scale. The first to do this was Korea, commencing an ambitious cross-checking program in the late 1970s. More recent attempts have been made by China and a handful of other countries (e.g., Indonesia, Bulgaria, Azerbaijan, and Albania). A feature of the systems developed by these countries is that they require taxpayers to submit copies (or a list) of invoices with their regular VAT returns, details of which are then entered into a central database. Following is a discussion of the models adopted in Pakistan, Korea and China.

Pakistan: Sales Tax Automated Refund Repository (STARR)

The Pakistan Central Board of Revenue (CBR) has developed software to authenticate the validity of vendors issuing VAT invoices used by other traders to claim input credits. Refund claimants (purchasers) are required to submit, in electronic format, the name, vendor’s TIN, value of goods or services purchased, and the VAT charged, for each purchase for which input tax credit is being claimed in that period. The total of the VAT in these invoices is compared with the purchasers’ input credits claimed to ensure all credits are included. The software then compares each invoice with the central database to ensure that:

- The vendor TIN is valid and relates to an active taxpayer;
- The vendor reported output tax liabilities in that period at least equal the VAT on the invoice(s);
- If other invoices from a vendor were claimed in that period, the total VAT is considered; and
- The vendor has not been blacklisted (suspected of fraud, large tax arrears, in bankruptcy).

This requires a nationwide information system with access to account data. Good results have been achieved in the initial use of STARR, particularly with the checks to ensure that the vendor is still an active registrant and has reported sufficient output tax. Reportedly, over 12,000 cases of false invoices were
identified in a 4-month period 2 or 3 years ago. Little is known about the costs of systems development or the operating costs, but it appears to be a relatively simple system to develop and operate. According to estimates, in 2002 it was taking the CBR around 15 minutes of computer time to validate 600 invoices.

This is not a complete invoice matching system and therefore avoids the complexities and inefficiencies of such systems. A system along similar lines could have some benefits for VAT administration in India, but clearly has limitations with a State based VAT where interstate transactions are not tracked.

**Korean Invoice Matching System**

Korea commenced development of a computer-based invoice-matching system in the 1970s when electronic data capture was not readily available. The system required the tax administration to transcribe data from paper copies of invoices supplied by vendors and purchasers. Data capture was time-consuming, costly, and prone to error. Taxpayer compliance costs were also high, given that suppliers and purchasers were required to submit copies of invoices with their VAT returns. The system identified numerous mismatches, and considerable administration resources were consumed in examining these. Most mismatches were not due to fraudulent claims, but instead were the result of transcription errors, incomplete data, and valid timing differences. A form of large-scale invoice cross-checking continues to be undertaken in Korea today, requiring general VAT taxpayers to supply the tax authority with summary information of purchases and sales invoices (replacing the earlier requirement that traders submit copies of invoices).

**China: The Golden Tax Program**

The State Administration of Taxation (SAT) has been working since 1993 on programs to crosscheck VAT invoices. Earlier efforts produced numerous mismatched invoices due mainly to errors in transcribing data from paper invoices to the system. Taxpayers were encouraged to submit invoice details in electronic format to cut down on transcription errors. These efforts have evolved into what is now called The Golden Tax Program. The program has four sub functions:

- Identifying false invoices;
- Verifying VAT credit entitlements;
- Computerized audit (checking reported sales on returns with invoice data); and
- Assisting in audit selections (compares input/output ratios).

The SAT has developed a system for encoding essential invoice data in codes printed on the face of the invoice. Taxpayers are provided a computer chip with their unique code and supporting software (“Black Box”) to enable them to print on the VAT invoice for each sale codes encrypting information on the VAT numbers of the vendor and purchaser, the amount of the sale, the nature of the goods and the VAT charged.

As this data is being encrypted on the invoice it is also stored in a file that is submitted to the local tax office with the vendor’s encryption card and VAT return (when last viewed the data was submitted to the tax office
on disk, but this may have been updated by now). The data is extracted from the disc and input into the “golden tax” database. When the purchasers claim credit for the VAT on purchases each month they submit copies of each VAT invoice. The coded information on each invoice is scanned and entered into the golden tax database. Purchase invoices are crosschecked with the data from vendor invoices.

The program as described above was functioning in 9 provinces and major cities in 2003, but may have been extended to others by now. In 2003, approximately 400,000 of the 1.2 million regular VAT taxpayers were in the program. Invoices valued at RMB 100,000 or more must be recorded in the golden tax program, however, some taxpayers record all sales to other VAT payers in the program. The intention is to install the golden tax program in all provinces but systems development complexities have prevented this to date.

No information is available regarding the development and operating costs of the golden tax program. However, VAT revenues as a percentage of GDP have increased significantly in recent years and officials attribute part of this increase to the golden tax project.

The golden tax has achieved some success in identifying false or fictitious invoices and in verifying that the amount of credit claimed corresponds with the tax reported by the vendors. Both these functions are limited to invoices greater than RMB 100,000. The effectiveness of the program in the other functions (input/output analysis verifying sales) is seriously hampered by the lack of information on imports or sales less than RMB 100,000, and the partial implementation.

While the early results are encouraging, the costs of systems development and the “black box” hardware provided to VAT registrants are high.

7.4.6. Verification of refund claims by CPAs

Under Kenya’s VAT laws, refund claims exceeding a specified amount must be certified by a CPA registered with the Institute of Certified Public Accountants of Kenya. The law imposes sanctions on accountants who knowingly certify false claims. Tax authorities, traders, and accounting professionals all contend that this approach has benefits. Tax officials argue that it helps eliminate fraudulent claims, and reduces administrative costs. Kenyan officials report that the number of refund claims by exporters dropped by 40 percent following introduction of the scheme, suggesting that many firms had been submitting false claims. By placing the onus on CPAs to certify the validity of refund claims, the government has in effect outsourced, in part, its verification program. Large exporters support the arrangement because it speeds up refunds, and for this they are willing to bear the increased compliance costs. CPA firms are also in favor because of the opportunity to generate service fees.

To ensure that an added financial burden is not placed on traders requesting small refunds, CPA certification is required for larger refund claims only. This is achieved by setting the statutory threshold at an appropriate level. For the scheme to work effectively, it requires a high-integrity accounting profession, together with a
sufficiently strong tax administration and sound judicial system to enforce sanctions if required. It also requires acceptance by traders of additional compliance costs.

7.4.7. Preferential treatment of Good Compliers (“Gold” status scheme)

A number of countries give preferential treatment to taxpayers (especially exporters) with sound compliance histories. One approach is the so-called “gold” status scheme, under which exporters with good compliance reputations obtain accelerated VAT refunds. “Silver” status taxpayers, and those in lower groups, receive less prompt treatment. Introduction of such approaches frees-up scarce audit resources for more productive audit work. In countries with limited administrative capacity, this system can be introduced initially with manual procedures.

For example, Pakistan introduced it, with some success, in the late 1990s to improve the processing of VAT refunds, especially for exporters in the textile sector. The system was further improved, and basic computer applications were developed to provide information on traders’ compliance history, using information from the VAT, income tax, and customs administrations.

Under the scheme operating in Pakistan, refund claimants are categorized in three main groups:

- “Gold” for claimants exhibiting minimal revenue risk;
- “Silver” for moderate risk claimants; and
- “Others,” representing those of high or unknown risk

Gold refund claimants normally have their claims approved for payment, without a pre-refund audit, within 3-5 days. Silver claimants are assigned an upper refund limit, where claims not exceeding the limit are subject to a brief desk review and approval is given within 15 days. Post-refund audits are conducted at least once a year on two or three claims submitted in the past 12 months by gold and silver claimants. If the post-refund audits detect persistent inaccurate claims, the gold or silver status of a claimant is withdrawn.

Refund claims from taxpayers without gold or silver status are processed (paid or denied) within the statutory deadline. Claims are selected for pre-refund verification in the following circumstances:

- The claim is a first-time refund claim.
- The claim exceeds a value prescribed by the tax administration.
- The claim deviates from the regular refund pattern of the claimant.
- Previous claims have been rejected or reduced as a result of verification checks.
- The claimant has a record of poor compliance in relation to VAT and other taxes (e.g., nonfiling, and late payment).

The criteria used by Pakistan under the “Gold” taxpayer scheme are enlisted in the table below.

| Pakistan: Requirements to qualify as a “Gold” and “Silver” taxpayer |
### Gold

- Exporters with at least three years’ export history and net wealth exceeding a specified amount
- Proper books of account for at least the last three years
- No evidence of fraud or significantly overstated refund claims in the past three years
- History of accurate and timely tax remittance for all taxes and duties
- Bank certification that accounts are in good standing
- Records audited by the tax office for six of the past 24 months

### Silver

- Exporters with at least one year export history and net wealth exceeding a specified amount
- Proper books of account for the duration of taxable activities (or three years, whichever is the lesser)
- Consistent pattern of export activities and products
- History of accurate and timely tax remittance for at least the past 12 months
- No evidence of fraud or overstated credit claims in at least the past four refund claims
- Records audited by the tax office for three of the past 24 months

### 7.4.8. Payment for large purchases through the banking system

The widespread use of cash transactions in developing and transitional economies facilitates VAT and other tax evasion, simply because an audit trail may not be established for the tax authorities to follow in identifying and verifying sales and purchases. To tackle this problem, tax administrations have looked for ways of encouraging, and even forcing, traders to conduct their business through the banking system—particularly where larger amounts are involved.

Many countries (including France, Hungary, Turkey, and several other countries) require traders to pay for goods and services above a certain transaction threshold amount through the banking system. Failure to comply, results in a financial penalty. Azerbaijan has introduced a stronger incentive for businesses to move away from cash transactions. For a VAT-registered enterprise in Azerbaijan to be entitled to VAT credits on a business-related purchase, the purchase must be made through the banking system. If the purchase is made in cash, VAT credits are denied.

### 7.4.9. VAT bank accounts

A VAT bank account system was introduced in Bulgaria in July 2002, with objectives of reducing VAT fraud and speeding up processing of VAT refund requests. Under the scheme, each taxpayer registered for VAT
must open at least one VAT bank account. Further, a purchaser registered as a VAT taxpayer must deposit VAT payments into a seller’s VAT bank account if the VAT charged on the transaction exceeds a statutorily prescribed threshold. The VAT deposit must be completed at the time the payment for the good or service is made. VAT input credits will not be denied to a purchaser who has followed the procedures and paid VAT into a seller’s VAT bank account.

The figure provides an example of how the VAT bank account system works. In the example, Firm A sells goods to Firm B, who then sells the goods to Firm C. In paying for the goods supplied by A, B must make two payments—one for the VAT exclusive price of the goods, and the other for the VAT that is payable on the goods. Payment of the VAT by B must be deposited into A’s VAT bank account. The procedure is the same for Firm C in paying for goods supplied by B. At the close of the VAT period, B and C can use monies held in their VAT bank accounts to meet their VAT liabilities due and payable to the government.

Because B can demonstrate that the VAT due to A has been deposited into A’s VAT bank account, B can be confident that VAT credits will be allowed for the amount paid. Likewise, C can be confident that credits will be allowed for VAT credited to B’s VAT bank account. As a general rule, funds held in VAT bank accounts can be used for two purposes only—for payment to suppliers of the VAT included in the price of the goods or services, and for payment of net VAT liabilities due and payable at the end of the tax period. In very limited circumstances, monies can be retrieved from VAT bank accounts for other purposes, but only on condition that a taxpayer seeks the permission of the authorities to make the withdrawal; undergoes a tax audit; and transfers the required funds from the VAT bank account to the government bank account pending the audit outcome and clearance of the funds. If the audit determines that other tax liabilities are due and payable, the funds will not be returned to the taxpayer, and will be offset against those assessed liabilities.
For the vast majority of taxpayers this means, in practice, that funds held in VAT bank accounts are effectively frozen and are lost as working capital of a business. Very few Bulgarian VAT taxpayers have applied to the authorities to withdraw funds from their VAT bank accounts.

### 7.4.10. Deferring accounting for VAT on Imported Capital Goods

Investors importing large items of capital equipment often complain that the levying of VAT on their imports has a negative effect on their cash flow and thereby discourages investment (i.e., the investors are required to pay VAT before clearance of their goods, and then have to wait for the resulting excess credit to be refunded following filing of their next VAT return). One solution to this problem is for countries to grant VAT exemptions to the investors, thereby dispensing with the need for refunds altogether. Governments are, however, generally reluctant to do this because of the potential for abuse, and the pressure it creates to extend VAT exemptions to other imports. A viable alternative has been to permit VAT taxpayers to defer accounting for the VAT liability on the imported capital goods until filing of the next return. In this way, importers can offset the VAT liability with the input tax credit to which they are entitled.

The main characteristics of the scheme are as follows:

- The scheme is limited to registered VAT taxpayers who import large items of capital goods.
- Capital goods (both imported and domestic) are subject to the standard rate of VAT.
- Imports of capital goods by persons who are not registered VAT taxpayers are subject to VAT at the time of import. VAT is paid, as usual, before clearance of the goods.
- Importers of capital goods who are registered VAT taxpayers are permitted to defer accounting for the VAT liability until their next return is filed.
- In this return, the VAT applicable to those goods is reported as a VAT liability and, in the same return, the VAT input tax credit is claimed for the capital goods.
- If the importer is entitled to 100 percent input tax credit (equipment used exclusively in taxable activities) the VAT applicable to the importation, reported as a liability, will be completely offset by the corresponding input tax credit.
- The customs office is furnished with a copy of the VAT return to close their records of the importation.

### 7.4.11. Evaluation of various approaches to refund claim verification

The following table summarizes the benefits of various methods of verification of refund claims followed by various tax administrations across the world.

<table>
<thead>
<tr>
<th>Performance Criteria</th>
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<tbody>
<tr>
<td>Reduces or eliminates refund delay</td>
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<tr>
<td>Reduces number of refund claims</td>
</tr>
<tr>
<td>Enhances protection of VAT revenue</td>
</tr>
<tr>
<td>Reduces taxpayer compliance costs</td>
</tr>
<tr>
<td>Saves admin resources</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Approach to verify refund claim</th>
<th>Performance Criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reduces or eliminates refund delay</td>
<td>Reduces number of refund claims</td>
</tr>
<tr>
<td>Enhances protection of VAT revenue</td>
<td>Reduces taxpayer compliance costs</td>
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<tr>
<td>Saves admin resources</td>
<td></td>
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<tr>
<td>Service/Policy</td>
<td>base</td>
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<tr>
<td>---------------------------------------------------</td>
<td>------</td>
</tr>
<tr>
<td>Zero-rated supplies to exporters</td>
<td>Yes</td>
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<td></td>
<td>Yes</td>
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<td></td>
<td>No</td>
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<td></td>
<td>No</td>
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<tr>
<td>Large-scale cross-checking of invoices</td>
<td>No</td>
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<td></td>
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<td></td>
<td>No</td>
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<tr>
<td>Certification of refund claims by CPAs</td>
<td>Yes</td>
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<td></td>
<td>No</td>
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<td></td>
<td>Yes</td>
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<td></td>
<td>No</td>
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<tr>
<td>Preferential treatment of good compliers</td>
<td>Yes</td>
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<td></td>
<td>Yes</td>
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<td></td>
<td>Yes</td>
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<tr>
<td>Purchases paid through banking system</td>
<td>Yes</td>
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<td>No</td>
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<td></td>
<td>Yes</td>
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<td>No</td>
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<tr>
<td>VAT bank accounts</td>
<td>No</td>
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<td></td>
<td>No</td>
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<tr>
<td></td>
<td>Not proven</td>
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<td></td>
<td>No</td>
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<tr>
<td>Deferment of VAT on capital goods</td>
<td>Yes</td>
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<td>Yes</td>
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</table>
8. Management of Large Taxpayers

The experience of many tax administrations is that when all taxes are taken into account (income tax, VAT, and withholding taxes on wages and investment income) a small proportion of taxpayers is responsible for a major proportion of a country’s tax revenue.

In addition, typically, many large taxpayers have quite complex tax affairs, due to one or more of the following factors:

- They often comprise distinct and geographically-scattered operating entities;
- They undertake a diverse range of business activities and/or are involved in types of businesses that frequently raise complex or novel tax law interpretation issues;
- For some taxpayers, many transactions are undertaken with “off-shore” related parties, introducing the potential for profit-shifting practices;
- They have a high volume of transactions in the course of day-to-day business operations that have tax consequences;
- They employ complex financing arrangements and/or other tax minimizing mechanisms; and
- They use high-profile professional tax advisers, part of whose brief is to minimize the exposure of the business to taxation.

This combination of features (i.e., large revenue potential, propensity to use tax minimizing practices, and complexity of their affairs) inevitably means that these taxpayers present a high level of risk to effective tax administration. Any non-compliance can have enormous potential for tax revenue losses if it goes undetected. To address these sorts of issues, many tax authorities have established dedicated organizational arrangements that are designed to optimize the tax authority’s ability to closely monitor and control all the tax affairs of such taxpayers.

Reviews of the reasons for implementing a large taxpayer unit show that the main factors have been:

- **A need to secure revenue and improve management of arrears**: In most developing countries and transition economies, the most pressing reason for establishing a large taxpayer operation has been the need to secure tax revenue (i.e., either ensuring that tax revenue does not fall below a certain level, or alternatively, mobilizing additional tax revenue, primarily by reducing the level of non-reporting (filing) and non-payment) and to introduce basic systems to control delinquent taxpayers.

- **Use of LTU as pilot to introduce a new organizational structure, systems, and procedures**: Some countries have adopted LTUs as pilot projects for introducing a new organizational structure, systems and procedures for tax administration (e.g., Bolívia, El Salvador, Hungary, Uganda). Once they have established LTUs, which typically administer a limited number of taxpayers, several tax administrations have been able to extend the reforms introduced via the LTU to the rest of the tax administration. These reforms have included new organization principles new taxpayer identification
systems, new collection procedures (e.g., in the early 1990s, joint filing and payment procedures through banks or, more recently, electronic filing and payment procedures), and new computerized information systems.

**Improving audit**: In developed countries, one of the main reasons for establishing specialized large taxpayer operations has historically been to improve the audit of the largest taxpayers; most large taxpayer departments established in industrialized countries before 1990 were devoted to audit exclusively. In countries of the European Union, for example, the initial reason for establishing a special department to deal with the largest taxpayers was the need to improve audit programs, especially after introduction of the VAT in the 1960s and 1970s. In Australia and the United States, large taxpayer operations initially focused on auditing large taxpayers' compliance with the corporate income tax. In developing and transition countries, setting up a large taxpayer operation with a dedicated audit team may also permit closer scrutiny of audits by audit managers, thus increasing the chances that corrupt practices may be more readily detected and addressed.

There are variations in the organizational arrangements that different countries have put in place to administer the affairs of their largest taxpayers. Some typical features of LTU are discussed below.

### Features of Dedicated Large Taxpayer Units

<table>
<thead>
<tr>
<th>Feature</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Taxpayers covered</strong>:</td>
<td>depending on the identification criteria used, the taxes to be covered, and the resources to be committed, LTUs typically encompass some 50–80 percent of the tax revenue base.</td>
</tr>
<tr>
<td><strong>Taxes covered</strong>:</td>
<td>Most LTUs and large taxpayer audit units in developing and transition countries have as their mandate the collection, enforcement and/or audit of: (1) the VAT or a national sales tax; (2) excises and other indirect taxes; and (3) the corporate and personal income tax withholdings.</td>
</tr>
<tr>
<td><strong>Criteria used to identify client taxpayers</strong>:</td>
<td>recognizing that the amount of tax paid may not always be a good indicator of a company's tax potential, the IMF has recommended to many countries that they use a combination of criteria to identify taxpayers to be administered by their LTU, including: (1) annual sales/turnover; (2) total amount of assets; (3) tax arrears; (4) the level of imports/exports; and (5) specific economic activities. Of these, (1) is normally recommended as the primary criterion.</td>
</tr>
<tr>
<td><strong>LTU organization, reporting lines, and functions/structure</strong>:</td>
<td>while there are various models that can be employed, a fairly common approach is to establish at the operational level a fully multifunctional unit to administer the affairs of the specially designated large taxpayers. These functions would include registration, all information processing tasks, answering technical inquiries, collections monitoring and enforced collections, and taxpayer audit. In a number of countries, a fair component of the audit officials are</td>
</tr>
</tbody>
</table>
organized on an industry segment basis given the unique taxation issues some industries generate.

Typical industries signalled out for this specialist attention include banking and insurance, mining, oil, chemicals and pharmaceuticals, IT, and other specialist manufacturing. (In countries where large-scale privatization of public sector organizations—e.g., energy, banks, and airlines—is being pursued, it also makes sense to keep such initiatives under close watch given the increased likelihood of significant tax issues arising.) The primary objective of the LTU is to have a closely coordinated set of functions to monitor each taxpayer, or groups thereof, across all taxes.

In a number of countries, there is a counterpart LTU in the headquarters of the tax authority to set overall direction for the program, conduct research, develop strategies and plans, oversight conduct of the program of work and to provide general administrative support.

8.1. Large taxpayer arrangements in Netherlands

In January 1990, as part of a comprehensive reform of the Directorate General for Tax and Customs Administration, an organizational structure was adopted based principally on “taxpayer segments” (i.e., large corporate taxpayers, small business taxpayers, and private taxpayers).

The large corporate taxpayer division is responsible for all major tax administration functions vis-à-vis large corporate taxpayers, including monitoring compliance with their filing and payment obligations; audit; enforcing collection of arrears; and taxpayer services. The concentration of knowledge regarding the large corporate taxpayers has made the tax and customs administration a good counterpart for large companies and tax advisors. The practice of “account management” has given large companies the opportunity to talk with the tax administration and customs about problems in advance. The establishment of special target groups for banking, insurance, oil and gas companies, as well as advance rulings, have allowed the administration to have a significant impact in terms of ensuring the compliance of the large corporate taxpayers. The tax and customs administration has a “fiscal monitor” which reports annually on taxpayer compliance. The score for the large corporate taxpayer department is higher than for the other departments in the organization. In this department, there is special value placed on “knowing the business.”

The large corporate division consists of a headquarters office which focuses on supervising all large corporate operations within the tax and customs administration. It does not handle any operational issues directly. The headquarters unit supervises the operations of 11 LTUs nation wide.

The key functions of the LTU include technical advice, taxpayer services, audits, collections monitoring, and arrears collection. The corporate taxpayers send their returns to the 11 LTUs, but the final processing of
large business returns, as is the case with all returns and payment documents is done by a central processing unit.

The LTU administers the corporate taxpayers following a model of “account management,” which differs from the practice of the other tax offices.

The large corporate division is responsible for administering indirect taxes (the VAT and excise taxes), corporate income taxes, PAYE and payroll taxes, and on a test basis, customs duties. The large corporate division is responsible for the tax affairs of corporate taxpayers that meet two out of the three following criteria: (1) more than 50 employees; (2) assets in excess of the equivalent of around US$3.9 million; and (3) annual turnover in excess of the equivalent of US$15.6 million. The department controlled some 15,000 taxpayers during 1999, and collected VAT, excises, corporate, and personal tax amounting to some 60.1 percent of annual collections of the tax and customs administration.

The amounts of additional taxes assessed as a result of audit actions were: 4.9 percent of total LTU tax collection (1997), 6.5 percent of LTU collection (1998), and 7.0 percent of LTU collection (1999). As of December 1999, large corporate employed some 2,150 staff, around 7 percent of total staffing of the tax and customs administration.

8.2. Large Taxpayer arrangements in New Zealand

In January 1994, the corporate segment was established within the IRD. In 1995 and 1996, additional departments organized along taxpayer segments were established as the IRD management took the strategic decision to organize the tax administration around taxpayer segments which reflected different levels of tax compliance. By 1999, the three main taxpayers segments were (1) corporate (established businesses); (2) small business segment (newer businesses); and (3) individuals.

All corporate segment staff are responsible for the delivery of services to corporate customers. However, there is some degree of specialization. Solicitors and investigators are primarily responsible for undertaking audit activity to ensure that the correct amount of tax has been assessed. Business services staff are primarily responsible for handling taxpayers’ questions promptly and accurately, a priority for the corporate segment. This may include ensuring that assessments have been issued correctly, returns are received, overdue debt is paid and general tax inquiries are answered. To achieve this, the staff in the business services area have an extensive knowledge of Inland Revenue operations, including: technical skills; return and debt management policies; and the registration of new entities. For large corporate customers and some particular industry groups within a sector a senior staff member is assigned as an account manager. They act as the principal Inland Revenue contact for all tax issues for that customer.
The segment undertakes a number of initiatives aimed towards improving voluntary compliance, including a business advisory service and other educational programs. There is a liaison between corporate segment and policy advice division, as Inland Revenue works towards developing policy which strengthens its customers' voluntary compliance and can be smoothly administered. The rulings unit is responsible for developing binding rulings and developing and communicating technical policy to customers and Inland Revenue. Staff in the corporate segment are regularly involved throughout this process by providing advice and commentary on industry issues and technical interpretations on legislation and policy. The corporate segment administers binding rulings for transfer pricing.

Under the current organizational arrangements, the corporate segment is structured into sector units based on industry type and specialized tax needs. The main sectors covered include: international tax, computer tax audit, banking, insurance, non-resident entertainers, overseas contractors, manufacturing, services, resources, and crown (public sector entities). Each sector of the corporate segment is headed by a manager and consists of a mix of experienced investigating staff, solicitors and service staff who deal with technical inquiries. The corporate segment is managed as one unit, with a national office in Wellington and two main operational centres. The IRD Headquarters carries out strategic oversight of all corporate operations.

The scope of taxes covered by the division are the GST, excise taxes, corporate, and personal income taxes, PAYE and payroll tax, and other direct taxes. The corporate segment customer base ranges from large corporate to small mining operators. High-wealth individuals, large accounting and legal firms, and smaller subsidiary companies under the ownership of prominent multinational corporations are also integrated into the corporate's customer base. Customers fall into one of several categories: (1) groups of companies with a turnover in excess of US$100 million; (2) companies whose industry is governed by special tax legislation; (3) large companies who have non-resident ownership. Large corporate controlled some 12,500 taxpayers during 1999, and collected domestic taxes amounting to around 25 percent of annual IRD collections.

The amount of additional taxes assessed as a result of audit actions was: 2.8 percent of total LTU tax collection (1997), 3.4 percent of LTU collection (1998), and 7.9 percent of LTU collection (1999).

Number of staff employed: the corporate segment employs some 240 staff, around 5.5 percent of total IRD staffing.
9. Taxpayer audit

It is an established fact that taxpayers' perception of the probability of being audited strongly determines their degree of compliance. It is also true that the importance given by the tax administration to the audit function affects the ability of the organization to enforce compliance and level of tax collections. For e.g. Denmark which has a strong and sophisticated audit program has one of the highest compliance rates in the world.

As with any other tax, VAT can be evaded and a strong and effective audit program is, therefore, crucial to increase the risks for taxpayers of being detected, to identify discrepancies and to provide sanctions against those who do not comply. Audit has always been the sole treatment for compliance risk available to administrations and will continue to play a key role.

The most common methods of VAT evasion are broadly similar to those of traditional sales taxes and direct taxes—including non-registration of businesses, underreporting of gross receipts, abuse of multiple rates, and failing to account for tax paid by customers, not having proper tax invoices. However, the credit mechanism and zero rating offer additional opportunities, and VAT-specific fraud will include the use of fake invoices, classifying domestic sales as exports to benefit from zero rating, and the claim of VAT credits for ineligible purchases.

Despite the apparent similarities, VAT and direct tax audit practices need to differ reflecting the differing nature and risks of the two taxes. As already noted, a VAT liability generally arises monthly or quarterly and can be a significant liability even for a moderately sized business. Discrepancies can therefore grow rapidly over a year if defaults are not identified and addressed quickly. As a result, VAT audit activity must include short period-based checks during the year as well as some more comprehensive multi period, multi tax audits.

It has generally been observed that audit is most often the weakest component of VAT administration, early in the implementation phase. This is because a completely new law is introduced, and both the Department’s staff and the dealers are inexperienced with it.

Furthermore, audit resources are used for more immediate problems, such as processing returns, as the effect of non-compliance that is detected by audit, is not immediately noticeable. This failure of audit in the implementation phase can encourage bad behaviour and erroneous expectations by dealers. The repercussions of an ineffective implementation of the audit strategy can lead to significant revenue losses in the future.

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3 It is for this reason that the proportion of VAT staff allocated to audit can be far higher than the proportion if income tax staff on audit. In addition, coverage rates need to be several times higher than those traditionally regarded as acceptable for the income tax.
Detection of offences requires field audits by well trained officers, rather than desktop verifications. Desktop verification is only verifying what the dealer discloses to the Department. It is what the dealer does not disclose to the Department that is of more interest. The only effective way to get this information is to have a strong presence in the field.

A comprehensive audit strategy typically addresses the following aspects:

- **Coverage**: what percentage of dealers should be audited?
- **Selection**: how should the audit cases be identified?
- **Methods**: what type of audit should be performed, what should be the duration of an audit, and what approach should be taken by auditors?
- **Staffing and training**: what are the skill sets and staff resources needed to implement the audit programme and what type of training should be provided?
- **Monitoring**: what are the management systems needed to monitor the audit programme (including assigning targets, developing time standards, performing quality review and ensuring prompt collection of additional assessments)?

Limited resources and relatively large numbers of taxpayers to administer requires a systematic risk-based approach for identifying which taxpayers to audit. Case studies from across the world reveal the following key elements necessary for an effective audit case selection process:

- **The timely availability of accurate and comprehensive data**;
- **The availability of relevant knowledge and skills to analyse and priorities available data**;
- **To facilitate the feedback into updating audit case selection parameters and**;
- **The compliance risk management process at the strategic level**.

Other enablers that have been found to be critical are resources for the information technology systems and solid organizational commitment to the risk identification and assessment function.
9.1. Example of a VAT Audit Program

Typically an audit program includes the following types of checks and audits:

- Desk verifications: Annual desk based verifications based on a review of margins and ratios to the extent possible with internal data, and cross checking against other information held.
- Advisory visits: These are largely educational and take place as soon as possible after a taxpayer has registered. Their purpose is to inform the taxpayer and to ensure that record-keeping systems are adequate.
- Registration checks: Unannounced visits to firms to verify their registration status. These are the equivalent of the current sudden visits.
- VAT refund audits: Refund audits focus only on the period covered by the claim. These need not be conducted in 100 percent of cases, and therefore rational case selection is essential.
- Issue-oriented audits: These are the principal VAT field audit activity. They focus on a specific issue and on no more than one to two recent monthly or bi-monthly returns. They involve the review of accounting records, interviews with the taxpayer and site visits. Such audits are unique to VAT and have no parallel in Income tax audit.
- Comprehensive audits: In particular, where serious underreporting is suspected, a comprehensive audit of all tax liabilities is required. These comprehensive audits may be extended to cover several years.
- Tax Fraud investigations: tax fraud investigations for the most serious fraud cases

9.2. What renders audit programs ineffective?

The three main reasons rendering audit programs ineffective are: skill gap of auditors, complex rules/procedures, and the prevailing level of unethical practices. These have been explained in the following paragraphs.

9.2.1. Skill gap of auditors

Audit typically requires a higher-level of skills than those needed for most other tax administration tasks, and those skills are in short supply. These are specialist skills not traditionally held by government employees who are the ones that administer the VAT regime.

The skills required are the similar to that of accountants. They are highly skilled professionals, who command remuneration far in excess of that paid to a Government officer. Some governments have created a professional group separate from the clerical grades in an effort to bridge the gap in remuneration. It has had some success but there is still a significant gap that exists between the private and public sector.

Governments are able to offer other benefits such as security of tenure, flexible working time and a less demanding workplace in order to make the package more attractive.
9.2.2. Complex rules and procedures

International surveys show that most countries lacking an effective audit programme are also the ones where VAT rules and procedures are more complex. In a number of countries, tax authorities are convinced that the lack of effective audits can be offset through increased filing requirements.

Some countries have been attracted by the theoretical possibility of cross-checking all purchases and sales invoices to promote compliance. This approach has often reflected a concern that the refund system is abused. In several countries, requirements to audit 100 percent of the claims prior to refunding VAT further complicate matters. Not only does this policy delay the processing of refunds, it also implies that most audit resources are assigned to the verification of refund cases.

Since not all refunds can be audited in a timely fashion, a database of all purchase and sale invoices is seen as facilitating the verification of refund claims. The South Korean experience indicates that massive cross-checking of invoices is costly to administer, burdensome for dealers, and ultimately not effective in controlling evasion.

While information technology has improved spectacularly since then, the sheer volume of transactions continues to make massive cross-checking a daunting task. Moreover, it runs the risk of alienating taxpayers.

9.2.3. Unethical practices

The possibility of collusion between dealers and tax officials is significant during an audit. A common approach to deal with the risk of collusion is to organise auditors into teams, at least two for each audit. However, there is little evidence that this approach helps address the problem of unethical practices.

Another approach would be for a second audit team that has the confidence of management, on a random basis, to re-examine a period or periods already audited by an audit team. The downside of this is that the dealer has to undergo an audit twice for the same period(s), and it would be embarrassing for the Department to admit that they have a possible problem of unethical practices. An external independent firm could be enlisted by the Department to check its' auditors work. Ideally, this firm should have a background in tax auditing and should enjoy the support and confidence of honest dealers. Once unethical practices is proved the fullest penalties under the law should be applied to both the dealer and the officer.

9.2.4. Lack of Audit Selection and Monitoring System

Several tax administrations lack management systems related to audit selection, audit target-setting in terms of revenue-recovery and completion time, quality assurance and monitoring mechanisms. As discussed
earlier, these are the building blocks of a robust audit program. Absence of these has a debilitating impact on the same.

**9.3. Methods of audit selection**

In the following section we will discuss some of the commonly used methods of audit selection. There are many methods of selecting cases from audit ranging from an ad-hoc approach which relies on no pre-selection criteria to highly sophisticated audit risk and selection computer programs that prioritise audits based on stated criteria. Most administrations will use a combination of approaches.

There is little point in auditing dealers who present little or no risk to the revenue as it would be a waste of resources. Therefore, audit resources should be focused on where the Department’s greatest risks are.

**9.3.1. How does the Department determine where the risk is the greatest?**

One way would be to audit all taxpayers on a systematic basis but this would mean many dealers who were of no risk would get audited. It could also mean that the ones that were the biggest risk would get audited last or would come up for audit after they departed the jurisdiction.

The function of the Department is to protect the revenue. It is easier for the Department to protect revenue that is already in its possession (eg tax collected from exporters but due for refund) rather than attempt to protect revenue that it did not get and does not know that it should have (eg the evaded VAT). That is why all revenue authorities are reluctant to pay out refunds and many will not pay out a refund without a pre-refund audit.

However, the rigour for auditing refunds can lead to a misuse of resources. From a financial angle, there is no difference to the Department of paying out Rs 100 as a refund or not collecting in Rs 100 that was due to it. However, it is common for VAT administrations to be heavily influenced by the need to make refunds in designing their audit selection strategy.

Most VAT frauds that come to the attention of the revenue authorities are committed by individuals who have some criminal background or who are in extreme financial difficulties. The claiming of a VAT refund not due is a criminal offence so it is not surprising that criminals commit them. In this respect close liaison with the police can be of help, as a source of information, as they are very aware of the criminal elements in the community. The police may be able to provide useful information that can be fed into the audit strategy.

Extreme financial difficulties can cause even an honest person to become dishonest for the survival of themselves and their families. The government becomes a justifiable target, as it is not the same as defrauding another individual. Timely feeding of market information about bankruptcies and liquidations into
the audit strategy can help the Department ensure incorrect refunds do not go out dealers that may be inclined to defraud the Department because of financial activities.

Audit selection strategy could be based upon the size of the dealer. One hypothesis could be that it is less likely that larger dealers would need to defraud the Department as they have more to lose. Smaller dealers have less to lose and therefore may take calculated risks. But then it can be argued that a large dealer has more to gain as well. An evasion to the extent of 10 percent of the VAT liability may be a substantially huge inducement for a large dealer than a small one. Hence this has to be looked at on a case by case basis.

Another risk assessment could be based on whether it is a new dealer or an existing or established one. It is more likely that a dealer with a long history with the Department is more likely to correctly comply with their obligations than one that is new.

Experience overseas has been that the dealers most likely to commit frauds are dealers that have only recently started in business. Sometimes the business has been started with the express purpose of defrauding the revenue. Sometimes the business does not exist except on paper and it was solely brought into being to commit the fraud.

A sophisticated computer selection system is expensive and it requires information and time to develop so it can’t be used immediately on implementation and may not be useful for two or three years. Sometimes they can be so sophisticated they may never become useable.

Any method of case selection needs a human interface. To set in parameters and audit blindly according to those criteria is unlikely to be productive. The dishonest dealers will soon learn the parameters and arrange their results to the fit the Department’s satisfaction. Further, the selection criteria needs to be dynamic enough to take into account changing circumstances and new practices employed by dealers to defraud the revenue.

The head of the audit would be the ideal person to make this decision. He will have to decide not only who to audit but the limitations of his scarce resources and his ability to audit. However, he should be accountable for his decisions and should not make a decision in respect of a dealer with which he has a personal interest.

Some of the commonly used audit selection inputs include the following:

- Audit trails/spin-offs
- Risk profile
- Random sampling

9.3.2. Audit trails/ spin-offs
These may indicate likely defaulters dealing with a dealer currently under audit. For example an unregistered dealer may be making significant sales or purchases from the dealer under audit. The details should be taken down and enquiries should be made with the unregistered dealer to check for discrepancies. Failure to explain the same may indicate a possible case of unethical practices.

9.3.3. **Risk profile**

A dealer’s risk profile is based on his nature of business, scale of operations, corporate background (‘public sector’ or ‘private sector’, ‘registered company’ or ‘unregistered partnership’, etc), business relationships and most importantly his track record in terms of timely and error-free returns. Dealers defaulting on payment of VAT, defaulting on returns, filing late, raising flimsy objections against the Department’s rulings are the ones that form a high risk category and need to be audited more often.

9.3.4. **Random sampling**

Just because a taxpayer is showing perfect results to the Department does not mean that they are complying with all their obligations. They could be showing perfect results for only a portion of their business.

All dealers at some time should be subject to audit. Understandably the Department would want to audit the high risk dealers first but it needs to be careful that a dealer does not escape scrutiny just because his results conform to that acceptable to the Department. One of the criteria for audit should be the amount of time since the last visit. The longer this period gets the higher should be the risk-rating. This will ensure that all dealers get audited at some stage.

The case selection inputs as described above can be used in isolation or in conjunction with each other. However, it should be noted that these are only indicative and suggestive in nature. The actual case selection is a judgmental issue at the discretion of the Department. The Department would make a decision based on its overall risk perception and the prevailing business environment.

9.4. **Audit case selection factors**

Until experience is built up from actual audit results, the following types of factors can be considered. They are a mix of taxpayer specific issues and industry or generic factors which indicate that a VAT payer is in a higher risk category and therefore, would be more likely to be audited. The more of such factors are present, the higher the overall risk.
<table>
<thead>
<tr>
<th>Factor indicating higher risk</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxpayer has a bad return filing record</td>
<td>Base on the last 4 or 5 returns. Measure is more accurate if a range of taxes can be included</td>
</tr>
<tr>
<td>Edit checks of returns reveal a number of minor errors</td>
<td>A general indication of a poor attitude to compliance</td>
</tr>
<tr>
<td>Taxpayer has a bad payment record</td>
<td>Existence of current debt or a bad record over the past 2 years should be checked. Increased accuracy if other taxes also considered</td>
</tr>
<tr>
<td>Penalties imposed</td>
<td>Penalties imposed on recent returns for any reason</td>
</tr>
<tr>
<td>Newly registered taxpayer</td>
<td>A new taxpayer should be selected for early audit</td>
</tr>
<tr>
<td>Taxpayer has not been audited in last 3 or 4 years</td>
<td>Length of time since last audit influences level of risk</td>
</tr>
<tr>
<td>Previous audit identified material discrepancies</td>
<td>Prior results are a good indicator of continuing risk</td>
</tr>
<tr>
<td>Selected industries</td>
<td>Taxpayers in certain industries may be known to be more likely to evade</td>
</tr>
<tr>
<td>Business type</td>
<td>Businesses where all control is held by family members tend to more risky than larger businesses with effective internal control</td>
</tr>
<tr>
<td>Size</td>
<td>Revenue risk increases with the size of the business – measured by both turnover and liability</td>
</tr>
<tr>
<td>Ratio analysis</td>
<td>Without access to income tax data, ratio analysis is limited, but could include:</td>
</tr>
<tr>
<td></td>
<td>1. Input/output tax</td>
</tr>
<tr>
<td></td>
<td>2. Variation from industry norm and variation from previous period</td>
</tr>
<tr>
<td>Factors identified during visits</td>
<td>Advisory/validation visits and audits provide an opportunity to populate the case selection database with additional risk information such as:</td>
</tr>
<tr>
<td></td>
<td>1. Quality of financial records maintained</td>
</tr>
<tr>
<td></td>
<td>2. Whether an accountant is engaged or taxpayers prepares own returns</td>
</tr>
<tr>
<td></td>
<td>3. General attitude to VAT obligations</td>
</tr>
<tr>
<td>Refund factors</td>
<td>Comment</td>
</tr>
<tr>
<td>----------------------------------------------------</td>
<td>-------------------------------------------------------------------------</td>
</tr>
<tr>
<td>1. First refund claim</td>
<td>Special factors which indicate a high risk refund application could include:</td>
</tr>
<tr>
<td>2. Claim exceeds a predetermined level</td>
<td>1. First refund claim</td>
</tr>
<tr>
<td>3. Claim deviates from normal refund pattern</td>
<td>2. Claim exceeds a predetermined level</td>
</tr>
<tr>
<td>4. Previous refund claim rejected or significantly</td>
<td>3. Claim deviates from normal refund pattern</td>
</tr>
<tr>
<td>reduced</td>
<td></td>
</tr>
</tbody>
</table>

9.5. Audit Division—Roles and Responsibilities

Audit divisions at the headquarters level are sometimes divided into three broad subdivisions — audit policy and procedures, audit operations and audit statistics. The principal responsibilities of each of these divisions are generally as follows:

9.5.1. Policies and Procedures Section

- Conducts research on tax issues
- Conducts research on industry practices
- Establishes audit policies and procedures for the audit field operations
- Establish audit review policies and procedures for the audit review function that is responsible for quality assurance
- Establish policies and procedures regarding international audit, tax avoidance, transfer pricing, treaty assists and electronic books and records.
- Develops audit strategies and link with Departmental Mission and Vision
- Develop with provincial, municipal and field offices the audit corporate business plan
- Prepares audit circulars, procedures manuals and forms
- Identification of training needs based on information from operations and stats section
- Prepares and delivers training program and specific audit training on audit techniques, industries and indirect verification

9.5.2. Operations Section

- Establishment or formation of the national annual audit plan
- Establishment of risk assessment for file selection
- Selection of audit files based on risk assessment and profiling
- Implementation of national audit policies and programs
β Monitoring of national audit program achievement
β Monitoring of national audit policies application
β Assisting operational or field offices on large or complex taxpayer’s files
β Identify new audit practices that work well in India/State and ensure that the practice is shared with all auditors
β Assist in the identification of new operations methods for workload development including sector profiling, taxpayer profiling and development of audit projects

9.5.3. Systems and Statistics Section
β Compiling operational information from field offices
β Preparing management information reports and developing performance standards to evaluate the efficiency of audit operations in field offices
β Developing functional specifications for computer systems in respect of audit activities
9.6. Performance measures for VAT audits

Internationally, the following parameters are used to measure audit performance.

- Ratio of auditing function staff / Total tax administration staff to be 40 percent
- Proportion of taxpayers audited by taxpayer type and audit type
- Audit-time length by taxpayer type and audit type
- Number of audits completed per auditor year
- Percentage of audits resulting in assessment
- Percentage of audits where taxpayer accepted assessment
- Percentage of audits completed on time by audit type
- Amount of tax assessed by audit as a percent of annual collection
- Amount of tax paid as a percent of tax assessed after audit

An illustration of a dashboard used to reflect audit performance is shown below.
10. Ideas gathered for inclusion in CT-MMP

Following is a brief summary of the various ideas that have been gathered for inclusion in CT-MMP based on the study of leading international practices.

1. **Organizational design** – Functional organizational design along with a special unit for large taxpayers is proposed to be adopted in CT-MMP. Under this design revenue based performance measures have been replaced by measures of efficiency and effectiveness pertaining to each of the functional units. In line with international practices, it is proposed that operations design be separated from operations delivery and that audit function be separated from other branch office functions. Special emphasis has also been laid under CT-MMP on Revenue Forecasting and Strategic Planning functions.

2. **Registration and monitoring of dealers** – Based on international practices, the Economic Activity Coding has been proposed under CT-MMP. The system of online verification of dealer status is also brought under CT-MMP. With respect to dealer registration the following performance measures have been drawn into CT-MMP with appropriate customization of performance benchmarks.
   - After initial implementation, all TIN to be issued within three (3) working days of the receipt of registration application.
   - TIN should be issued immediately for large business taxpayers provided all relevant documentation is provided with the application.
   - Ratio of active (operating regularly) to total registered taxpayers > 90%
   - Ratio of taxpayers with more than one TIN to total registered taxpayers < 5%

3. **Return processing and tax payment** – With respect to return processing, online return filing and computerized return processing have been incorporated into CT-MMP. Electronic tax payment system has also been taken up for evaluation under CT-MMP change alternatives.

4. **Refunds** – The system of 100% computerized invoice matching, CPA certification of refunds and selective invoice matching as part of “Gold” taxpayer scheme are three schemes of refund processing which are being evaluated under CT-MMP. Elements of the IMF recommended model for refund processing are also being incorporated as part of change alternatives.

5. **Large taxpayer unit (LTU)** – The principles of constitution of LTU are being fully adopted under CT-MMP and it is proposed that the system of selection of dealers would be based on gross turnover criteria as is the international practice.

11. Conclusion
In conclusion, various aspects of VAT administration have been addressed in this paper with a level of detail which is available from published information or those which have been studied by Ernst & Young’s expert team. The systems documented may have undergone changes over a period of time since various VAT administration practices are still in evolution. Suitable solutions may be drawn up by various VAT administrations in India through customization of these international practices.
12. Bibliography

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