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INDIA'S RISK-BASED TAX AUDITS AND THE EVOLUTION TO RISK MANAGEMENT.

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ABSTRACT:

Modern tax administrations are beginning to recognise the value of self-assessment and voluntary compliance, and tax enforcement is shifting to a risk-based approach. This is due to two factors: first, it is impossible for any revenue administration to monitor and scrutinise every single taxpayer, and second, it is inefficient to frequently scrutinise low-risk, cooperative taxpayers. All of this is part of a comprehensive and collaborative strategy to improve taxpayer compliance by addressing compliance issues in a systematic way as part of multi-year strategic planning. As part of its numerous gradual changes, Indian tax administration (direct taxes) embarked on that route some time ago, albeit cautiously, and established a risk-based audit system known as a computer aided scrutiny system (CASS). However, despite the implementation of CASS some years ago, manual selection of tax audits has continued. Revenue management serves as a vital link between the state and its inhabitants. As a result, excellent revenue administration is a key characteristic of successful governance.

The effectiveness of audits is vitally dependent on a well-designed audit selection approach that focuses on high-risk taxpayers to give the most cost-effective conclusion. This, in and of itself, helps to promote voluntary compliance. The importance of compliance is overstated in our nation, which has resulted in a variety of challenges and concerns when the government is inefficient in combating tax evaders, as seen by recent headlines. Recognizing the importance of compliance, I wish to undertake a study that will focus on improving the efficiency of tax compliance. This paper investigates risk-based audits for tax compliance, concentrating on the definitions of such a system, the meaning of key words, the application of such a system, and its efficacy.

The paper's limited scope will focus on the benefits of such a system using examples from nations such as the Netherlands and comparing it to Democratic India. Furthermore, a suitable model may be developed by researching the compliance structures of other nations and creating an effective tax compliance system based on risk management.

Keywords: Computer Aided Scrutiny System, OECD, Risk-Based Audit Selection, Risk Management Strategies.

INTRODUCTION.

The subject of tax compliance is frequently addressed from the perspective of taxpayers, using the traditional premise of anticipated utility maximisation.[1] This theory holds that the taxpayer will not pay his taxes as long as the cost of compliance surpasses the advantages of noncompliance, putting the responsibility of utility maximisation on the taxpayer, depending on the likelihood of being caught by the tax department. This is why

[1] Andreoni, J., B. Erard, and J. Feinstein. 1998. "Tax Compliance." Journal of Economic Literature 36 (2): 818–60

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the tax department is in charge of enforcing the law. Several articles have expanded on this basic scenario to include the tax administration's involvement as a strategic player.[2]

These studies begin with a game theory foundation, employing traditional conclusions from principal-agent theory with asymmetric information.[3] These models improve because they account for the fact that the probability of detection (assuming that taxpayers will "naturally"—without detection effort—understate their income) is not exogenous, but rather depends on information provided by taxpayers to the administration when filing their tax returns.[4] Knowing that the income reported by taxpayers is dependent on their own activities, the tax administration is required to maximise projected tax and penalty collections net of audit and enforcement expenses, subject to a restricted budget.[5] The outcome of such a game gives a compliance plan for taxpayers as well as a tax administration audit approach.[6]

The tax administration is expected to keep three OECD-issued behavioural aspects of tax compliance in mind. To begin, compliance is affected by individual characteristics such as gender, age, and education, and in the case of a firm or industry, it is affected by the management sector, size, or financial position of the same.[7] Second, compliance is dependent on the fairness of the taxation system, as viewed by each taxpayer. Taxpayers evaluate fairness based on three factors:[8]

a) the amount of taxes to be paid.

b) his or her specific treatment by the tax administration in comparison to other taxpayers; and

c) the government's utilisation of public monies.

Third, compliance has a social domino effect, which implies that if compliance is the social norm, everyone has a stronger motivation to comply.[9] When noncompliance is the social norm, each taxpayer has a higher motivation to conform.[10]

In this situation, audits serve a specific role. Audits are first used to discover specific incidents of noncompliance and subsequently to resolve such cases.[11] Second, audits encourage compliance since they may uncover potential noncompliance and can be targeted at specific groups of taxpayers.[12] Finally, audits provide chances for the administration to acquire information on the health of the tax system and maintain track of the various techniques of tax evasion. This provides an opportunity to evaluate the tax system and

[2] Eds. Munawer Sultan Khwaja, Rajul Awasthi & Jan Loeprick. 2011. "Risk-Based Tax Audits: Approaches and Country Experiences". World Bank 13
[3] ibid
[4] Khwaja, Awasthi & Loeprick, Supra N.2
[5] Alm, J., R. Bahl, and M. Murray. 1993. "Audit Selection and Income Tax Underreporting in the Tax Compliance Game." Journal of Development Economics 42 (1): 1–33.
[6] Khwaja, Awasthi & Loeprick, Supra N.2, 14
[7] OECD (Organisation for Economic Co-operation and Development). 2004a. "Compliance Risk Management: Audit Case Selection Systems." OECD, Centre for Tax Policy and Administration, Paris.
[8] Ibid, 2004b
[9] Ibid, 2004c
[10] Ibid
[11] Khwaja, Awasthi & Loeprick, Supra N.2, 16
[12] ibid

administration.[13] The separation of the selection of taxpayers for audit and the implementation of the audit is critical to risk-based audits.

The division has two benefits: it helps to combat corruption among collectors, and it prohibits strategic targeting of taxpayers for the purpose of extortion. As the committee on auditing's primary emphasis, it also aids in the development of professional auditing would its only purpose. Furthermore, linking auditor remuneration to the column of modifications and penalties issued by them frequently puts pressure on auditors to manipulate the statistics in their favour. Such mechanical accuracy in business just biases audits against taxpayers, and auditors encourage strategic selection behaviours, and the audit function suffers as a result of the non-separation of selection and execution, The audit function as a whole no longer serves a purpose.[14]

DEFINITION OF THE TERM RISK.

Policymakers have grown increasingly conscious of the necessity of policies that encourage company expansion while guaranteeing voluntary tax compliance in recent years. Examining or inspecting every single taxpayer is neither desirable nor practical in the current environment. As a result, the revenue administration must rely on good compliance management. Fostering voluntary compliance through a self-assessment system in which taxpayers comply with their tax responsibilities without interference from tax authorities necessitates the development of contemporary risk-based audit techniques.

The International Organization for Standardization defines risk as "*the state, even partial, of a lack of information linked to, understanding or knowledge of, an occurrence, its effect, or likelihood.*" Thus, "*Risk is frequently defined in terms of possible occurrences and consequences, or a mix of these.*"

RISK-BASED AUDIT SELECTION.

In 2004, the CBDT began to transition to a more accurate self-assessment system based on risk-based audits backed by information technology, and a new direct taxes statute prepared in 2009 should put audit selection in line with the Board's risk management approach. Tax authorities across the globe are focusing on the hazards of taxpayer noncompliance.[15] The efficient audit selection approach finds taxpayers who are likely to be noncompliant, i.e. who are most likely to result in substantial audit adjustments and fines.[16]

The technique works as follows:[17]

(a) a score is given to each taxpayer, based on (a) certain attributes (size, industry, compliance history) and

(b) knowledge acquired during previous audit campaigns (whatever the selection strategy). These techniques enable the tax administration to build several "profiles" of taxpayers and hence to identify

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[13] ibid

[14] Khwaja, Awasthi & Loeprick, Supra N.2, 16

[15] OECD (Organisation for Economic Co-operation and Development). 2006. "Strengthening Tax Audit Capabilities: General Principles and Approaches." OECD, Centre for Tax Policy and Administration, Paris.

[16] Khwaja, Awasthi & Loeprick, Supra N.2, 20

[17]

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> *those most likely not to comply with tax rules. This selection strategy combines several of the benefits of random selection (intelligence building for tax administration, statistically robust approach), while addressing its limitations in terms of effectiveness. It is the preferred audit selection strategy in many developed countries' tax administrations and one that has been advocated by international organizations in transition and developing countries.*

However, this method has one disadvantage in that it necessitates a significant investment in effective data gathering and IT infrastructure. So, the issue with such a system is that the government must be established in order to undertake such a costly expenditure. However, this is also a wise investment for future tax management. It can thus be difficult in underdeveloped, data-poor emerging countries.

TAX SYSTEM IN INDIA.

According to data analysis from 2007, India has about 30 million taxpayers. India maintains the core concept of trusting taxpayers while verifying their claims.[18] So the approach that was adopted in India was a selective system that was established in 1987. The selection of auditing remained discretionary, allowing tax authorities unrestricted authority, and it has been a cause of numerous complaints since then. The Central Board of Direct Taxes (CBDT) did, however, provide criteria for choosing cases for audit in its yearly action plans in the 1990s. However, a senior officer must still provide consent, allowing leeway for discretion and giving possibility for exceptions.

The CBDT proceeded in 2004 to develop a self-assessment system based on risk-based audits and backed by effective information technology. This system's components are as follows:[19]

- A nationwide computer network that connects all tax offices. Given that there are over 750 offices in 540 cities and towns across India, establishing this network was a massive undertaking.
- All results are entered into a central computer system. Electronic filing of returns became obligatory for all corporate organisations in 2006. This was expanded in 2007 to include additional firms with an annual revenue of more than Rs 4 million, and professional entities were obliged to have their accounts audited by professional accountants.
- Returns are processed by computer. The computer system is used for initial processing and confirming the basic correctness of results.
- Audit criteria. On a yearly basis, the CBDT used to determine the criteria for audit case selection. CASS (Computer Aided Scrutiny Selection) now determines which cases will be audited.
- Parameter specification The CBDT appoints a senior-level team to specify a significant number of secret criteria. Furthermore, the system flags high-order requests of tax breaks.
- Utilization of computer models. The computer models create outliers within each parameter using Gaussian distributions, and then a sophisticated scoring algorithm is used to the data to develop a risk score for taxpayers. The CBDT then establishes a limit on the number of audits for each parameter chosen, beginning with the highest-risk instances and moving to the lower-risk ones.

[18] Ibid, 97
[19] Ibid, 98

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The notion of yearly information returns, which contained data on six expenditure and investment categories, was established. All information, such as investments and expenditure items, recorded by third parties, banks, reserve banks, property registrars of state governments, and corporations, is transmitted to the IT department, where it is electronically collected and put into the CASS, which then compares the information using data from income tax returns. The system finds specific situations to be scrutinised based on the established criteria.

In 2009, a new direct tax code was written, and it will shortly be submitted to Parliament for passage into law following a broad public discussion.[20] Section 156 of the Direct Tax Code details the procedure of choosing a tax return for examination.[21] According to Section 156(2), the selection of cases for examination "shall be made in line with the risk management strategy developed by the Board in this behalf." (Ministry of Finance, India, 2009).[22] The provision also specifies a time period within which the taxpayer must be notified that his or her case has been chosen for review.[23]

A NETHERLANDS CASE STUDY - RISK MANAGEMENT STRATEGY

The Dutch Tax and Customs Administration's (DTCA) strategic aim is compliance, which is defined as taxpayers' desire to fulfil their tax responsibilities by disclosing pertinent information properly, on time, and in full.[24] The DTCA maintains a customer-focused, courteous attitude toward taxpayers.[25] Corrective action is used to encourage voluntary compliance and, as a last option, the criminal court system is used to enforce it (DTCA 2008).[26] In the Netherlands, the system follows the Risk Management process, but in India, the system simply follows a risk-based audit system. In this approach, the Tax Administration determines which instruments will be utilised to encourage compliance and prohibit noncompliance depending on taxpayer behaviour and the administration's capability.

Risk evaluations are carried out in conjunction with subjective information from taxpayers and objective information from tax returns and third parties, and such risks are then picked for treatment after the policy defines methods and prioritises goals.[27] Legislation, communication, services, and company visits are examples of preventive actions.[28] Audits, fraud probes, and administrative fines are all repressive measures.[29] Furthermore, certain relatively new technologies, such as horizontal surveillance and enforcement communication, as well as coordination with other enforcement agencies, are accessible.[30]

The DTCA provides services like as service desks, contact centres, and prefilled tax forms, which have a variety of advantages, including a reduction in the amount of mistakes and compliance expenses. This

[20] Khwaja, Awasthi & Loeprick, Supra N.2, 99
[21] ibid
[22] ibid
[23] ibid
[24] Jon Hornstra, Khwaja, Awasthi & Loeprick, Supra N.2, 83
[25] ibid
[26] ibid
[27] Supra N. 24, 84
[28] Ibid, 84
[29] ibid
[30] ibid

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contributes to the development of a trusting relationship between taxpayers and government officials. They simplify fiscal regulations even further to eliminate mistakes and ensure that pre-filled returns are accurate and efficient. To encourage collaboration and further build a system of transparency, the department has built a horizontal monitoring mechanism between the authorities and companies.

The DTCA then assists these efforts by sharing compliance responsibilities with the private sector. They also encourage interaction between all types of businesses and tax consultants in order to avoid mistakes on tax returns. As a consequence, rather of relying on tax audits, difficulties in taxes are predicted before they arise. Correction and minor fines are also used as repressive weapons. This gives taxpayers more transparency and confidence, and it enhances the country's business climate. As a result, this benefits the administration by lowering operational expenses.

Although it is ideal to collect risk-related data at the national level, risk data must also be collected at the regional or local level.[31] Risk management isn't only about electronic databases and analysis; it's also about being aware of what's going on in the real world.[32] Annual reports and tax returns (regional comparisons of assets, comparisons of turnover ratio), information on business development, on-site observations (to ensure that all sales are recorded at the point of sale or to compare the real cash balance with the administrative cash balance), traditional and digital desk research to discover new entrepreneurs, professional judgment, and the intuition of the regional tax auditors.[33]

EPILOGUE.

The risk management process and the outcomes of risk assessments should be adequately reported. Without exposing any trade secrets, the board should ensure that the business discloses key risk concerns to the market in a clear and understandable manner. Disclosure of risk factors should focus on those recognised as more important and/or rank material risk factors in order of importance. In India, the system appears to be all pink and wonderful on paper. However, because the foundation for tax audit selection is secret and dependent on the tax department's internal system, the system is vulnerable to several flaws, such as enforcing and taxing on the basis of the tax auditors' decisions.

While tax officers no longer have unrestricted authority, they nevertheless have a lot of leeway in directing the scope of a tax examination. Furthermore, the officials are more concerned with serving their own personal interests than than the country's overall well-being. Genuine taxpayers, as well as the country's growth, suffer because of this mentality. Finally, India's tax system continues to punish tax evasion when it should be encouraging tax compliance. In India, the department's responsibility is to focus on revenue collection rather than tax compliance. It is not the legislation that is at fault, but the execution and mindsets of the individuals in question, when the authorities have such a purpose in mind.

As a result, it is the government's responsibility to build an effective training facility for future tax auditors, in which the tasks of auditee selection and implementation are carried out by two separate branches that are both

31 Supra N. 24, 88
32 ibid
33 ibid

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knowledgeable in their respective fields. In compared to the Netherlands, India's taxation system is a complex puzzle with a lot of stress for taxpayers and practically no advantages, or rather, perks that are frequently connected to system inefficiencies and delays. The Netherlands may be short on people, but it appears to be making up for it in terms of execution thanks to its unique cost-cutting measures.

In compared to the Netherlands, India's taxation system is a complex puzzle with a lot of stress for taxpayers and practically no advantages, or rather, perks that are frequently connected to system inefficiencies and delays. The Netherlands may be short on people, but it appears to be making up for it in terms of execution thanks to its unique cost-cutting measures. Risk management, rather than enacting a one-sided tax legislation aimed solely at revenue collection, can lead to a more successful implementation.

Having a clear and comprehensive vision, goals, and strategy, securing political commitment and backing, and maintaining a central risk management department in charge of identifying hazards, accumulating risk-related information, such as assessments of random sample results; sustaining a learning cycle; and focusing on national hazards. Understanding taxpayer behaviour, either through randomly selected audits, a nationwide compliance survey, or both Learning about new instruments available, such as services, horizontal monitoring, legislative solutions, and enforcement communication to improve compliance, and other such methods, serve as key lessons in developing a better, more efficient tax system.[34]

[34] Supra N. 24, 89