Iranian National Tax Administration
(INTA)

## Working Paper:

# Role of Tax Audit in Improving Tax Compliance: Case of Iranian Taxation System

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## 1. Introduction

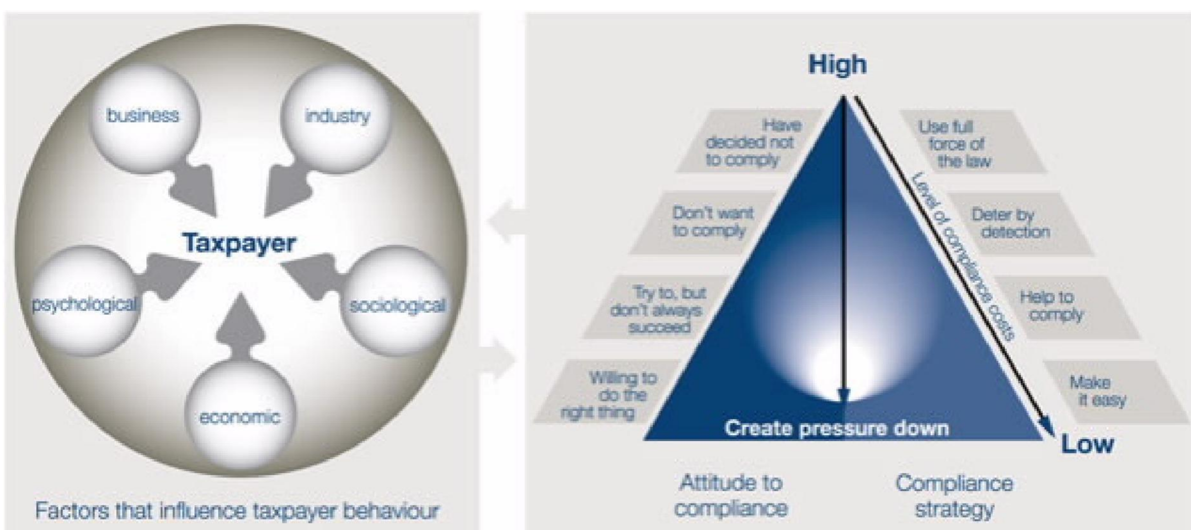
In any country, taxation is assumed to be one of the most essential and important instruments of governments' fiscal policies and as such, the improvement of the efficiency of taxpayers' voluntary compliance and the effectiveness of collection procedures are of great significance. One important tool for improving efficiency and effectiveness of a tax system is to use appropriate tax audit methods. The present working paper is aimed at investigating how to make use of tax audit as a crucial strategy in OECD's compliance model, and how to locate it in the overall Iranian taxation system.

## 2. An analysis of compliance behavior and taxpayer treatment strategies

Tax compliance, by definition, is characterized by the extent to which taxpayers observe tax laws and regulations of their country. This includes such tasks as declaring one's real income, filing tax returns, and paying due taxes within legal deadlines. On the other hand, tax audit is to investigate the documents and accounting books of taxable individuals on the basis of tax laws and executive instructions in order to make certain that whether or not the taxable income/profit declared by the taxpayer is exact and if the accounting standards and legal regulations have been observed. It also includes tax assessment processes. According to this definition, the ultimate output of a tax audit program is to assess the taxpayer's due legal tax by the tax authority; so, in practice, tax audit is perceived as a strategy against taxpayers' non-compliance behavior. Needless to say, tax administrations do not suffice to this single strategy but make use of other strategies, too, to fight non-compliance behavior in proportion to the taxpayers' motives. Taxpayers' incentives are taken into account because we do not deal with a homogenous population of taxpayers and since the circumstances under which they behave changes over time. Therefore, in order to develop appropriate strategies, it seems to be necessary to analyze taxpayers' tendencies towards compliance or non-compliance behavior.

On this basis, OECD (2005) proposes a compliance model which is now adopted by most tax organizations. As it is shown in figure (1), such factors as economic, business, psychological factors, etc. do shape taxpayers' attitudes towards the tax system and it is on the basis of these attitudes that they choose their compliance or non-compliance behavior. Taxpayers may move between two extremes of complete compliance to complete non-compliance. On the other hand, tax administration may respond to these behaviors appropriately by using a variety of strategies. The model shows that a mixture of appropriate strategies including tax audit methods, tax sanctions, provision of advices, training, reform of executive procedures, etc. may influence the taxpayer's behavior. The ultimate goal of adopting various strategies is to affect taxpayers' behavior as much as possible so that the tax authority can move as large number of taxpayers as possible towards the bottom of the pyramid, that is, towards "tendency for doing the right things". Through the implementation of these strategies, the number of taxpayers for whom the tax authority needs the complete implementation of tax laws or a full process of tax audit will decrease and this will, in turn, lead to a decrease in the costs of tax organizations. The implementation of tax audit for all taxpayers will lead to a loss of organizational resources and to the misallocation of resources. Therefore, it is essential for tax authorities to select appropriate cases for audit and to adopt appropriate methods of tax audit. The selection of audit cases should be based upon the risk of tax evasion on behalf of the taxpayers in question.

***Figure (1): OECD Compliance Model***



## 3. Tax audit as a tax compliance strategy

OECD compliance model prescribes tax audit for changing taxpayers' noncompliance behavior. At the first stage, the tax authority should make sure that the most high-risk taxpayers are being selected for tax audit purposes, if its aim is to decrease the levels of noncompliance because the objective of the audit case selection is to direct the tax administration's limited audit resources to the most likely non-compliers. This will usually involve a full knowledge of taxpayers' conditions. By "conditions", here I mean specific circumstances under which the risk of non-compliance increases.

The next stage, and perhaps the most critical one, is to identify and to prioritize the risks identified for each segment on the basis of likelihood and consequences. To do this task, we resort to a risk rating matrix (Table 1). Having assessed the risks, the most significant must be identified. The aim of such a table is to actively manage the most serious risks and, at the same time, to achieve a reasonable balance of risk management across all key market segments. In doing so, it is important that consequences not be measured in revenue terms alone. The impact on the integrity of the tax system overall, and the level of community confidence in the tax administration, should also be considered.

***Table (1): Typical risk rating matrix***

| **Consequence**<br>**Likelihood** | **Insignificant** | **Minor** | **Moderate** | **Major** | **Severe** |
|---|---|---|---|---|---|
| Remote | Negligible | Negligible | Low | Low | Significant |
| Unlikely | Negligible | Low | Low | Significant | High |
| Possible | Negligible | Low | Significant | High | High |
| Likely | Low | Significant | High | High | Extreme |
| Almost Certain | Low | Significant | High | Extreme | Extreme |

The results of the matrix should be taken into account against other variables such as the availability of tax administration's resources in dealing with risks as well as the cost effectiveness dealing with the risk.

The third stage is related to the identification and allocating the risks to the taxpayers wherein taxpayers are segmented on the basis of their turnovers. For each defined taxpayer segment (or sub-segments) risks should be identified using information gathered from various sources including tax returns, prior audit reports, customs, and other government organizations.

The fourth stage includes developing tax audit programs and plans. An effective audit program will have significantly wider impacts than just raising revenue directly from audit activities. By selecting the highest risk cases, efficiently detecting non-compliance, applying appropriate sanctions, and publicizing results of audit activity (either generally or specifically), taxpayers are put on notice that attempting to avoid tax will result in a high likelihood of detection and imposition of significant sanctions. Thereby, a well planned audit program can provide the administration with significant leverage across the community rather than only impacting on the taxpayer selected for audit and collecting the tax that should have been paid in the first place. Additionally, in a tax system that is perceived to be fair and equitable, punishing taxpayers who do not comply builds community confidence and encourages compliance from the broader population as compliant taxpayers support the administration's efforts to deal with non-compliance.

The scope of audits conducted should reflect the risks to be addressed. In the following section, a brief outline of types of audit methods used in audit programs developed for dealing with taxpayers with different attitudes towards the tax system is presented:

- *Registration checks*: A quick check on businesses to establish that they are correctly registered;
- *Advisory audits*: A visit to newly established businesses advising obligations in terms of tax types, filing of declarations, payment of amounts due, records to be maintained (Very appropriate when introducing new laws);
- *Record keeping audits*: the visit points out the obligations of the taxpayer in regards to the keeping of records and is followed up with penalties if the taxpayer continues to disregard record keeping requirements;
- *Desk audits*: Basic checks conducted at the tax office when the auditor is confident that all necessary information can be ascertained by conducting the examination in the office;
- *Single (or specific) issue audits*: Focusing on a single tax type, a single theme or a single period;

- *GSS/VAT refund audits:* Verifying the taxpayer's right to a refund prior to processing the refund. Usually undertaken for first refund claims as well as where the refund claim varies significantly from established patterns and trends;
- *Audit projects:* Audits can be organized as a separate project for specific groups of taxpayers: an industry (e.g. construction) or a line of business (e.g. retail) and / or certain items from the declaration of profit and loss account (e.g. depreciation); to address a particular risk or to establish the degree of non-compliance in a particular sector;
- *Comprehensive (or full) audits:* All tax obligations over a number of tax periods. As they are usually time consuming, should only be applied to taxpayers if there is an indication of under reporting that will impact across taxes; and
- *Fraud investigations:* Involve the most serious cases of non compliance that have criminal implications- fraud, evasion, and criminal activity. Require special skills in investigation and evidentiary requirements.

## 4. Tax audit programs in Iran

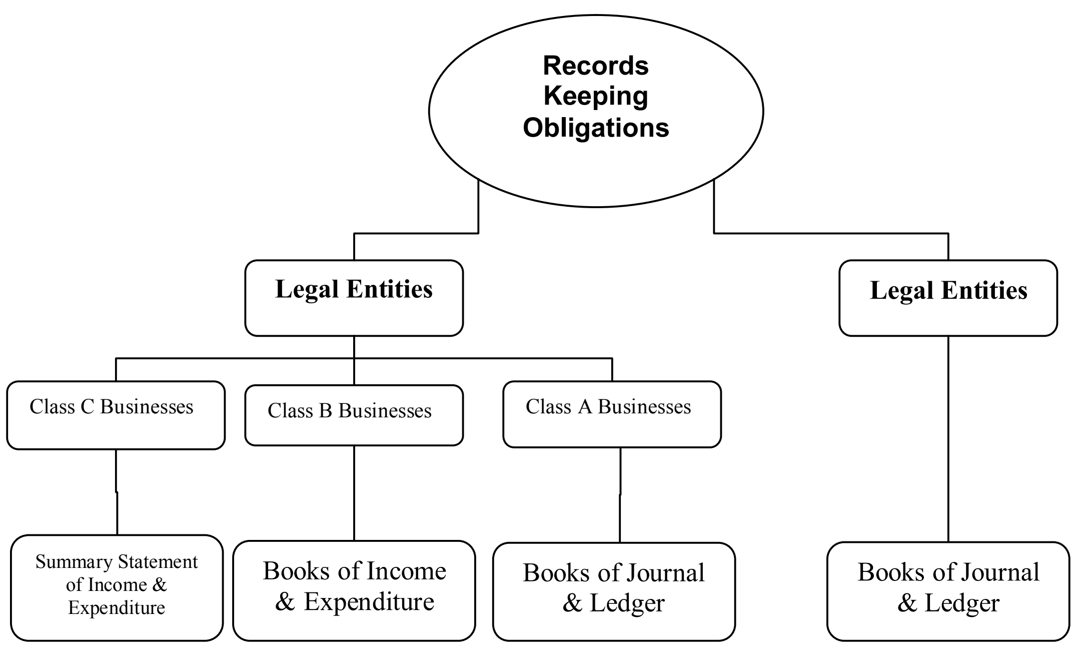
The overall structure of tax audit in the OECD's proposed model of compliance is based upon three components: 1) identification and segmentation of taxpayers; 2) selection of high risk taxpayers on the basis of risk-based management; and 3) the audit of the selected taxpayers in accordance with the audit programs developed for individual taxpayers.

Since in Iran all tasks of taxpayer identification, tax assessment, claiming for the assessed taxes and the collection of taxes are submitted to INTA as per Art 219 of Direct Taxes Act, so all stages of tax audit are based on the procedures and directives approved by INTA. It should, however, be mentioned that there is no such a thing as a well-managed tax audit program in Iran. In order to implement an effective tax audit strategy in Iran as recommended by optimal compliance models, first of all, we would rather describe current procedure of tax audit in Iran as well as the points it has in common with an optimal well-managed audit program and the points which may be regarded as transition areas. The same way as an optimal tax audit, the current tax audit procedure in Iran may be categorized into three main components of "classification of taxpayers", "selection for audit", and "specific case audits".

### 4.1. Classification of taxpayers

Iranian taxpayers are classified into different groups on the basis of the type of their legal obligations for records keeping. All legal entities are required to register their financial activities in the books of journal and ledger as prescribed in the Commercial Law and are obliged to keep their accounting books and the relevant supporting documents in accordance with the accepted accounting principles and standards. But as for real entities, they are classified into three classes on the basis of their records keeping obligations. Taxpayers of Class A have the same obligations as legal entities with regard to recording their business activities in the books of journal and ledger and keeping the supporting documents as well as observing the accepted accounting principles and standards. Class A includes 12 sub-categories of business activities. Class B includes taxpayers who are required to record their books of income and expenditure. Samples of these books are prepared and supplied annually by INTA. Class B includes 19 business sub-categories. Class C includes owners of businesses which are not subject to the obligations of classes A and B. They are obliged to maintain a summary statement of their income and expenditure according to the criteria and samples determined by INTA. The figure (2) summarizes the legal obligations of members of business classes A, B, and C.

***Figure (2): Iranian Taxpayers' Records Keeping Obligations***



### 4.2. Selection for audit

As was implied above, in OECD compliance model, taxpayers are selected for audit on the basis of their risks. In other words, determining taxpayers' risks in order to set appropriate strategies for dealing with them is of great significance. In Iran, taxpayers are not directly selected for audit on the basis of their risks and all taxpayers must be audited except for those who are subject to provisions of Art 158 of Direct Taxes Act whereby INTA is authorized to announce, by publishing an advertisement within the first half of each year, that in respect to some tax sources, wholly or partially, and in regions which it considers appropriate, INTA will accept, without further examinations, the tax returns to be filed on time by relevant taxpayers in the next year, and only a number of tax returns will be examined by the way of sampling and according to the provisions of Art 181 of Direct Taxes Act. As you see here, Art 158 of Direct Taxes Act is implicitly focused on the notion of risk. Moreover, INTA has some short-term and long-term programs within TARA[1] project in order to do risk-based tax audits.

#### 4.2.1. Establishment of LTU Head Office

In 2001, LTU Head Office was established in Tehran in order to investigate large legal entities' cases. As a matter of fact, the very objective of establishing an LTU is to examine those taxpayers who are larger than others in terms of their assets and income levels. In the time of establishing LTU, it was decided that tax files of companies with gross sales of more than Rls. 10,000,000,000 or tax amount of Rls. 1,000,000,000 or more be referred to LTU. Since in tax audit, taxpayers' sizes should be taken as an important criterion for identifying their risks, it can be said that the establishment of LTU indirectly focuses on the notion of risk since taxpayers who are audited within LTU are significant in size and are high-risk from the viewpoint of non-compliance. Tax evasion of such taxpayers is very important due to their more considerable turnovers.

In addition to Tehran province, LTU offices are now established in some other provinces including East Azerbajan, Isfahan, and Khorasn Razavi. At the same time, some head offices have established LTU units for the investigation of "businesses and professions income tax" being levied on real entities wherein tax audit activities are done in group.

[1] Tax Administration Reform & Automation

### 4.2.2. Group investigation of major tax cases

Another measure adopted by INTA by which the notion of risk has implicitly been taken into account in tax audit activities is to examine the cases through group investigations. In LTU units, tax audits are, all the time, done in groups while in other tax offices, just some of the important cases (not all cases) are investigated in groups. In such offices, most cases are investigated individually by tax officials of the same offices.

### 4.2.3. Inspecting the activities of particular taxpayers in their business locations as per Art 181 of Direct Taxes Act

On the basis of this article, for the purpose of supervising the implementation of tax laws and regulations, INTA is authorized to dispatch bodies of three persons for inspecting and controlling the statutory books of accounts of taxpayers. These bodies are allowed to inspect accounting books of the current year of those of previous years and, if necessary, to take the books to the relevant tax offices for further investigation, in return for issuing a receipt certificate for the taxpayers. The implementation of Art 181 is typically based upon the reports of a dismissed accountant, rival companies, tax officials of other tax offices, or of different government authorities such as Ministry of Intelligence, General Inspectorate of the State, Customs, and State Supreme Audit Court whereby it is certain that there is significant hidden information. These inspections normally lead to the issuance of tax assessment sheets on the basis of taxpayers' real incomes. Therefore, Art 181 of Direct Taxes Act is directed towards cases audits of high risk taxpayers.

### 4.2.4. Future plans for risk-based tax audits

In addition of the measures already done, INTA is going to design other measures within the framework of TARA project with the purpose of the implementation of risk-based tax audit programs. One major project in this relation is "risk-based selection for audit" project which has been divided into short-term and long-term components. This project will be implemented whenever the ITS[2] software is established and installed. Thus, in distant future, INTA will be able to select high risk cases for audit by making use of ITS, by having integrated access to the information needed, and by using a full-mechanized

[2] Integrated Tax System, one of the most important components of TARA project

intelligent system without any needs for human interference. In such a case, the tax official will have no roles in case selection process and high-risk cases will be delivered to him through the ITS system in order to be investigated and assessed. Moreover, in short-term when a trial version of ITS software is to be tested, INTA will implement its short-term risk-based audit program which is necessary for overcoming such problems as:

- Increased tax evasion rates resulted from non-identification of high risk taxpayers;
- Too much time consumed for the investigation of some cases; and
- Insufficient time devoted for the investigation of some cases prior to the full installation of ITS.

### 4.3. Tax audit program in Iran

In Iran, the tax audit of any particular taxpayer will be on the basis of the relevant business class and the obligations thereof, but it will be different in different tax years. The tax year is a solar year beginning at the first day of Farvardin (21st day of March) of each year and ending at the last day of Esfand (20th day of March) of the same year. However, in case of taxable juridical persons, whose fiscal year, which is determined under their statute, does not coincide with the tax year, the income of their fiscal year shall be taken as the basis for assessment of their taxable income. The time limit for submission of tax return, balance sheet and profit and loss account of such persons shall be 4 solar months after the end of their fiscal year. Different types of tax audit are classified into the following as per the provisions of Direct Taxes Act:

#### 4.3.1. Examination of taxpayers' statutory books

This method is relevant to those taxpayers who are obliged to keep statutory books including legal entities and real entities owning class A or B businesses. They are obligated to submit to the tax office of the district where they reside, their tax return, balance sheet and profit and loss account on basis of their statutory books of accounts, and to pay the applicable taxes, not later than four months after the expiry of each tax year. The tax office shall examine the tax returns of taxpayers who are subject to income tax categories not later than one year from the date of receiving the tax return. This examination will be based upon a "tax audit directive" issued by INTA. For the following reasons, observing the provisions and instructions of this directive being aimed at offering a standard paradigm of efficiency and effectiveness in tax audit is of great importance:

- Standardization and the creation of the same integrated procedure of investigation and tax assessment;
- Presentation of a standard method of preparing tax reports;
- Documentation of tax reports; and
- Presentation of effective methods of monitoring and internal control of tax audit activities.

If the tax offices recognize that the accounting books and the supporting documents submitted by a taxpayer are capable of being investigated, their tax auditors (tax investigation experts) will do the following measures in their investigation process:

- The discovery of mistakes and errors, frauds in accounts keeping etc. resulting in decreases of taxable income of taxpayers;
- The audit of taxpayers' costs in order to determine deductible costs as per provisions of Direct Taxes Act and the relevant by-laws;
- The audit and calculation of incomes that are exempted as per relevant laws and regulations as well as the calculation of fixed taxes;
- The audit of amounts deducted third parties as withholding tax;
- The calculation of taxpayer's taxable income in accordance with tax laws and regulations; and
- The preparation of tax calculation reports on the basis of the above information.

After the stages mentioned above, taxpayers are notified of the results of investigation which are now printed as tax assessment sheets. If the tax assessment sheet is not issued within the due legal deadline, or if the issued tax assessment is not delivered to the taxpayer within 3 months after the expiry of the one-year due deadline mentioned above, then tax return thereof will be taken as finalized.

On the basis Art 272 of Direct Taxes Act, Iranian Audit Organization, certified accountants, and members of audit institutions which are members of Iranian

Association of Certified Public Accountants (IACPA) and are assumed to do legal audits or inspections, are all obliged, in case of being requested by taxpayers, to draw up tax audit reports in accordance with samples prescribed by INTA and to submit to them in order to be presented to relevant tax authorities. These reports should include the following components:

A) Commenting on the adequacy of taxpayers' accounting documents and records for tax audit as per the provisions of tax laws and in accordance with accounting principles, conventions, and standards;
B) Determining the taxable income of taxpayers as per the provisions of tax laws and other relevant regulations;
C) Commenting on taxes withheld and paid to tax authority;
D) Other cases to be determined by INTA on an annual basis being reflected in tax report samples prepared by INTA;

Tax offices shall verify and accept the said above tax audit reports without further investigation and will issue tax assessment sheets on their bases. Of course, the taxpayer is required to attach his financial statements to the tax audit report and to submit it to the relevant tax office along with his tax return within 3 months from the deadline for filing returns (providing that the financial statements are prepared in accordance with accounting standards by the same certified accountant or audit institute that prepares the tax audit report). Moreover, INTA is authorized to submit the audit of financial statements and the preparation of tax reports of real and legal entities to certified accountants or audit institutes. In that case, INTA will be obliged to pay the charges thereof in accordance with its relevant regulations.

### 4.3.2. Tax investigation on the basis of tax indications

The taxable income of taxpayers shall be subject to ex officio assessment in the following occasions:

A) Where the tax return and profit and loss account, or the income and expenditures account and profit and loss account, whichever be applicable, are not submitted up to the stipulated time limit;

B) Where the taxpayer refrains from presenting the books or documents of accounts in the premises of his business in spite of written application of the relevant tax office; and

C) Where according to the tax office, the books of accounts, papers and documents presented for assessment of the taxable income, are considered to be inappropriate for examination, or they are rejected due to non-observance of legal criteria and the relevant regulations.

In cases of ex-officio assessment, the tax officer must, in first place, perform necessary investigations and studies, and obtain needed information from different sources, whether public or private. Then he should select, from among different indications, one or more indications that conform to the conditions of the taxpayer and object of his business. He should mention the reasons of choosing the relevant type of indication or indications and their amounts, with sufficient justification, in his report of examination. The tax official should, then, apply the pertinent stipulated coefficient or coefficients to the selected indication or indications for determining the taxable income of the taxpayer. In case of applying coefficients to more than one indication, the average of products so calculated, shall constitute the taxable income. Thus in this method, the taxable income is the product of the multiplication of the two quantities “tax indication” and “tax coefficient”:

Taxable income in the ex officio assessment = tax indication × tax coefficient where tax indication is any factor being effective in the assessment of taxable income of a given taxpayer in any type of business activity taking into account his business circumstances. These indications are listed below:

- Annual purchase
- Annual sales
- Gross income
- Levels of production in case of factories
- Value of the good will
- The sum of amounts received by notary publics as fees for the registration of documents, wages, collection of charges, consumption of stamps, etc.
- Other factors to be determined by the Committee for Scheduling Tax Coefficients

Tax coefficients are certain figures that when multiplied by the tax indications, the product will constitute the taxable income in cases of ex officio assessment. In cases where the taxable income is to be assessed on ex officio basis, but no coefficient is determined for the relevant case or by the schedule of coefficients, the appropriate coefficient shall be determined by the local Board of Settlement of Tax Disputes with due regard to the coefficient applicable to similar businesses.

### 4.3.3. Investigation within self-declaration program

INTA is authorized to announce, by publishing an advertisement within the first half of each year, that in respect of some tax sources, wholly or partially, and in regions which it considers appropriate, the administration will accept, without further examination, the tax returns to be filed on time by relevant taxpayers in the next year, and only some tax returns will be examined by the way of sampling. At present, self-declaration is applied only to owners of business classes A, B, and C (i.e. real entities).

### 4.3.4. Assessing taxes

In respect of some of the income sources and for the years and places that INTA may consider appropriate, the administration may determine the taxable income of all or some taxpayers subject to certain guilds, by seeking the opinion of the relevant guilds, and collect the applicable taxes, which shall be considered as final. If it becomes evident that a taxpayer left his business as from the beginning of a tax year or in the middle thereof, or was unable to work due to reasons beyond his control, his taxable income shall be computed, and the tax applicable shall be collected, in proportion to the period of engagement in business, provided that the said situation is confirmed by the Board of Settlement of Tax Disputes.

## 5. Conclusion

In OECD model of compliance, taxpayer risk assessment is of a great significance in improving the efficiency and effectiveness of tax audit strategies and other strategies developed for treating taxpayers. Nowadays, as a result of recent developments in audit methods and the application of risk-based models in this area, it is quite essential for an effective tax system to have a risk-based audit approach to the assessment of taxpayers' taxes. In Iran, there has been no explicit risk-based tax audit model so far but INTA has resorted to some specific measures as the establishment of LTU units and providing for preliminaries of group tax audit activities in tax offices and therefore, has indirectly paid attention to the significance of the notion of risk in tax audit. Meanwhile, INTA has adopted a "Risk-Based Audit Selection" project as one of the main sub-projects of TARA (Tax Administration Reform & Automation) Project and this can be interpreted as INTA's being serious for implementing risk-based tax audit programs in Iran. It is certain that the implementation of Risk-Based Audit Selection project will enable the INTA to select audit cases on the basis of taxpayers' risks so that the time and the costs of audit will significantly decrease.

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