



International Seminar in Alicante (22 / 23 April 2010)

“External Financial Control Facilities and Public Revenue Audits”

Case Study

“Review of Risk Management in the Income Tax Assessment Process”



RECHNUNGSHOF
RHEINLAND-PFALZ



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1.1 Government and Administrative Structure

The Federal Republic of Germany is a federal parliamentary republic of states.

Govt. structure

Federal Government

[Bund]

Revenue authorities

Federal Ministry of Finance

[Bundesministerium der Finanzen]

Customs

as a tool of federal administration (approx. 40,000 staff)

External financial control

Federal Audit Office

[Bundesrechnungshof]

16 independent states

[Bundesländer]

16 State Ministries of Finance

[Landesministerien der Finanzen]

Over 600 local tax offices [Finanzämter]

as a tool of regional government administration (approx. 125,000 staff)

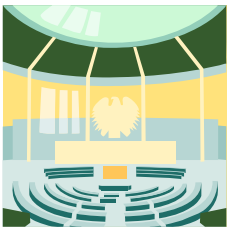
16 State Audit Offices

[Landesrechnungshöfe]

(Federal Audit Office)

Approx. 12,000 local authorities [Gemeinden]

as constituent parts of the states under constitutional law



1.2 Public Revenues

Without revenue there can be no expenditure.

Tax revenue = biggest source of income (80 % of public revenue)

Main taxes

Income tax (tax on wages)

Value-added tax (sales tax)

Energy tax

Trade tax

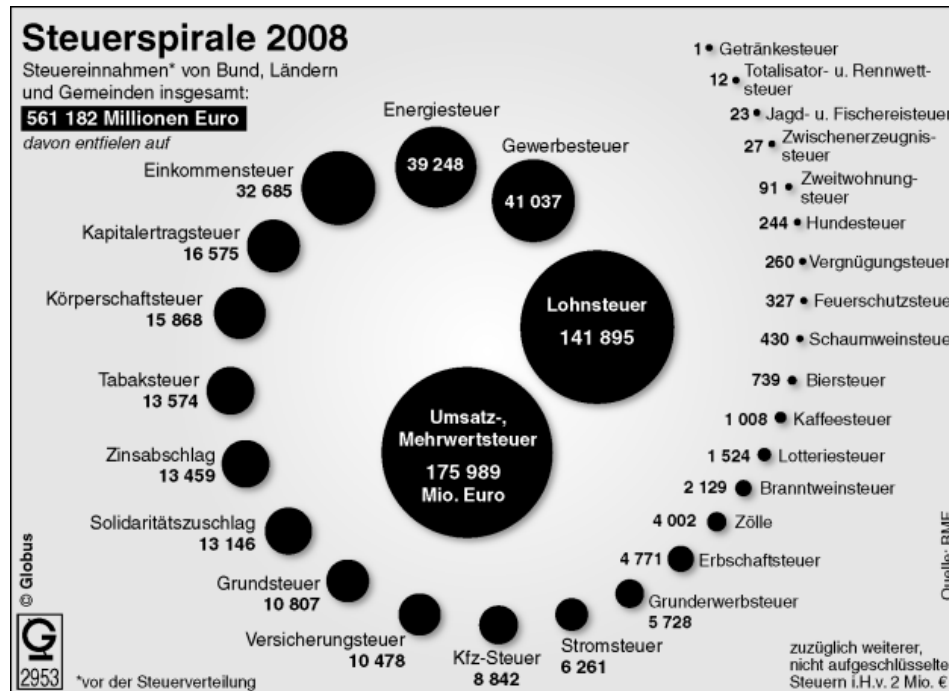
Where does the revenue go?

Fed. Govt., states, local authorities

Fed. Govt., states, local authorities

Federal Government

Local authorities



1.3 Revenue Authorities and Financial Supervision of the State of Rhineland-Palatinate

Revenue authorities

Ministry of Finance in Mainz
= Supreme state authority

Regional Finance Office [Oberfinanzdirektion] in
Koblenz with central fiscal data administration
= Intermediate authority

26 tax offices with 4 tax collection offices
= Local authorities

Over 7,600 staff in revenue authorities

Over € 19,000,000,000 in tax receipts



Financial supervision

Rhineland-Palatinate State Audit
Office [Rechnungshof Rheinland-Pfalz]
= Supreme state authority

Based in Speyer

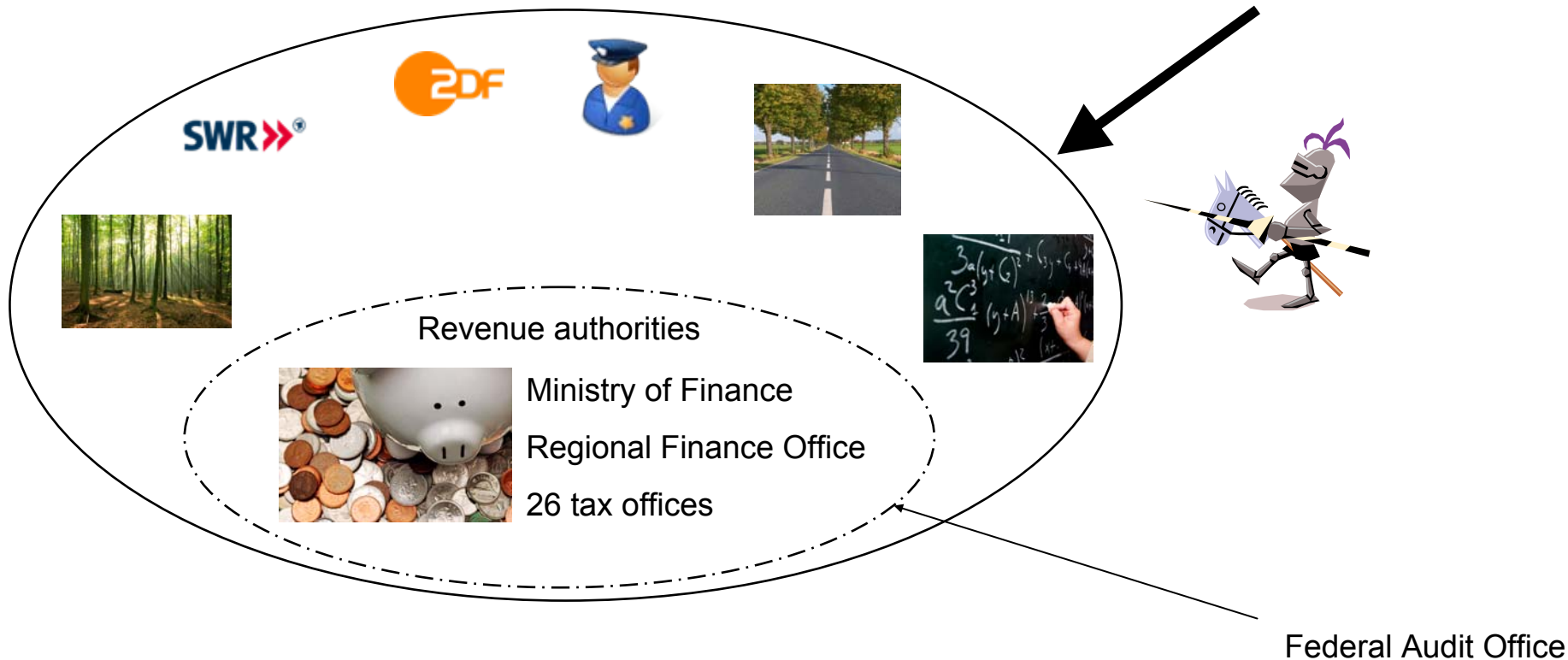
Offices in Koblenz and Trier

Approx. 160 staff

2.1 Powers of Audit

Management of budget and economy for entire state

State Audit Office



≠ Powers of audit with taxpayers themselves

≠ Authority to issue directives to audited bodies



2.2 Types, Scope and Objectives of Audit

- General audits
= Regular audits at tax offices



- Specific-focus audits
= Investigation as to how specific tax affairs are handled



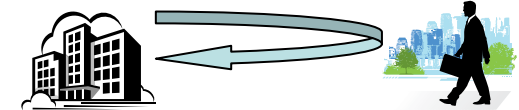
- Cross-reference audits
= Comparison of processes employed by different tax offices



- Orientation audits
= Familiarisation with new issues, procedures or developments



- Review audits
= Verification as to whether matters arising in earlier audits have been dealt with



- Legality of assessment and imposition of taxes
- Full payment of taxes
- Efficiency of organisation and staffing requirements for revenue administration
- Improvement and assurance of quality of work

2.3 Audit Planning

Medium-term plan

- Three-year plan with major emphases

Audit brainstorming

- Pooling of ideas from all staff
- Following service factors are helpful
 - e.g.: Fiscal relevance
 - Tax deficit risk
 - Insights from previous audits
 - New laws / amended legislation
 - Degree of automation / internal audit
 - Evaluation of fiscal literature and press articles

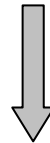


Annual work schedules (fiscal year)

- Based on own initiative
- No legal requirements

2.4 Audit Instruments

- Mainly spot checks on taxation cases
- Machine selection on the basis of certain criteria / facts
 - by the Audit Office itself accessing the data or
 - by the data processing centre of the revenue authorities (ZDFin)



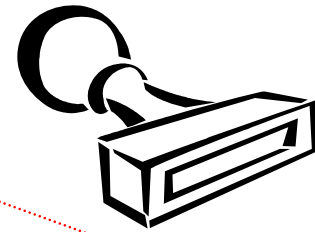
Local investigations

- Inspection of individual tax files and data records
- Gathering of information through questionnaires
- Interviews with the relevant staff
- Evaluation of databases held by tax authorities
- Actions based on results of internal audits
- Use of internal administrative directives



2.5 Audit Process

- Outline concept (objectives, main aims)
- Orientation phase (initial local investigations)
- Detailed concept (audit process, assignment of tasks)
- **Local investigations**
- Summary of audit findings
- Final audit meeting with audited body
- Audit report
(notice of any shortcomings, appraisal, conclusions and recommendations)
- Response process
(where applicable with the Ministry of Finance or Regional Finance Office)
- Reporting of major findings to state parliament [Landtag] and state government [Landesregierung] (article for annual report)
- Formal approval and discharge process on behalf of the state government



Internal controlling

Not public

Public



Case Study

“Review of Risk Management in the Income Tax Assessment Process”



3.1 Administrative Framework for Revenue Authorities

- More than 30 million cases of income tax are processed each year (Germany-wide)
- Complicated taxation legislation subject to constant amendments



- Workload continually increasing
- Broadening of remit of revenue authorities
- Staffing cuts needed (budget constraints)

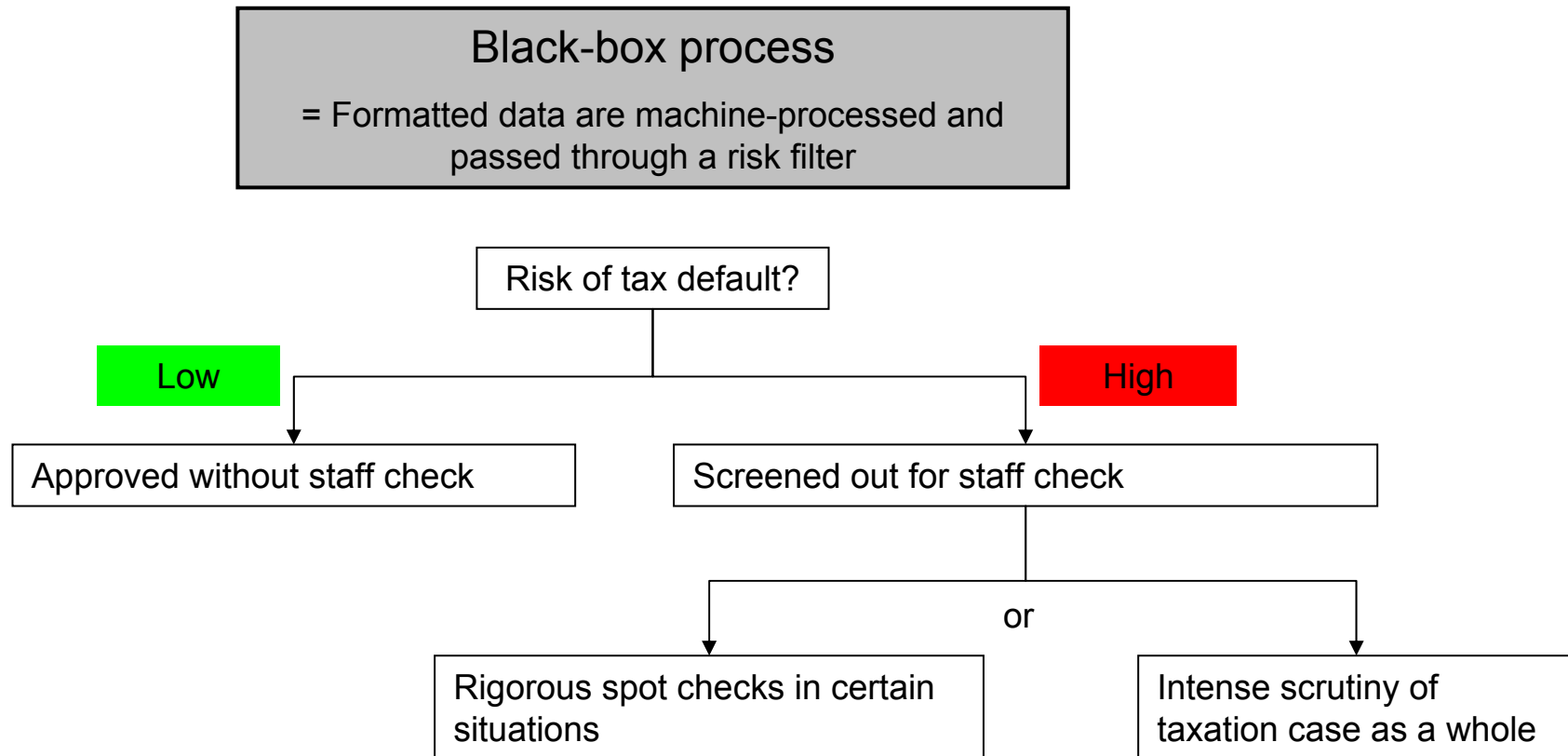
- Work situation “tense”
- Bulk processing
- Quantity ↔ Quality

3.2 Guidelines for Processing Income Tax Returns

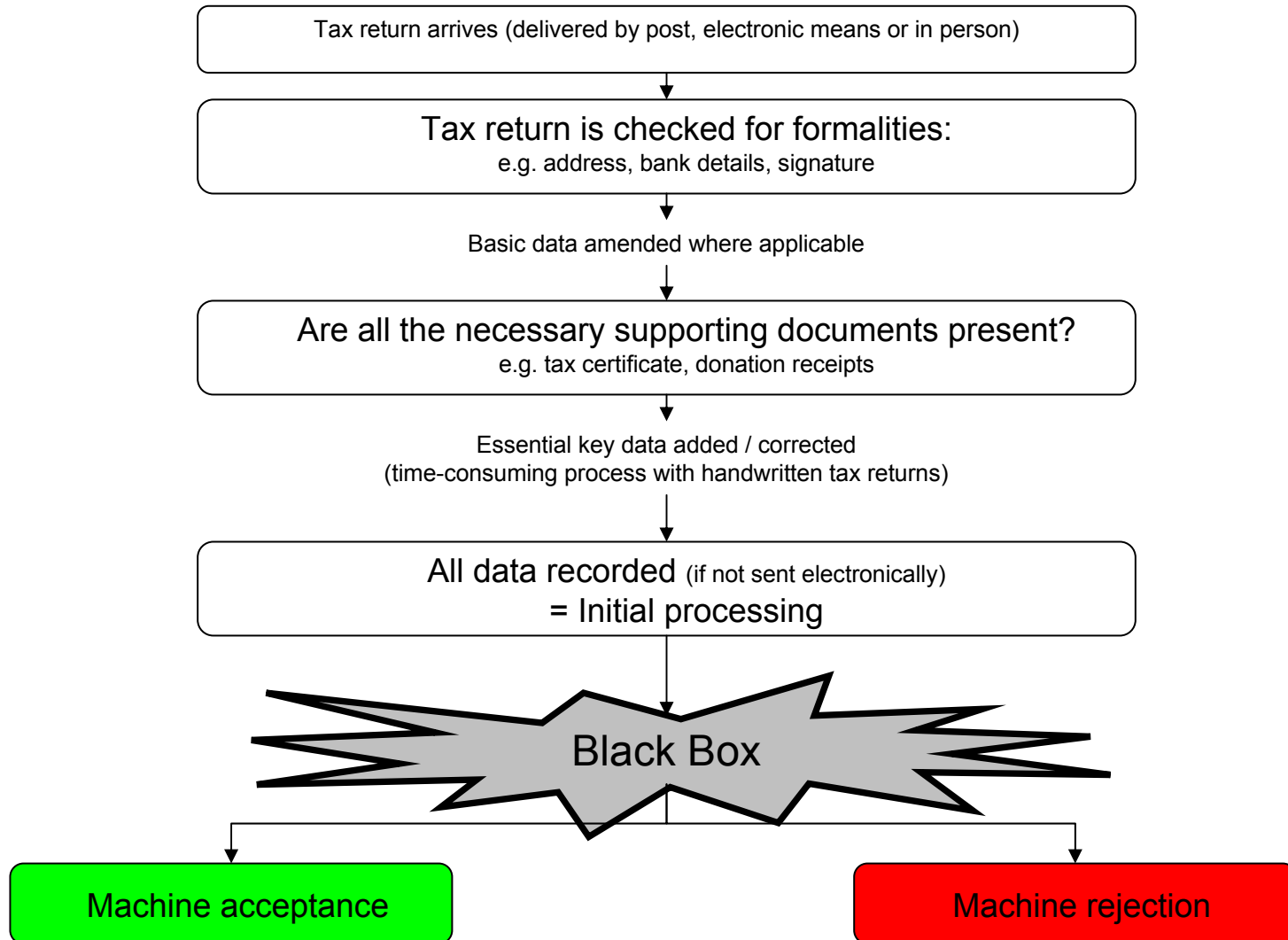
- Legal requirement is lawful and fair taxation
- Amount of work ought to be in line with potential outcome in terms of taxation:
 - Cost-effectiveness of casework / analytical approach to viability of input
 - Deployment of staff in proportion to tax default risk
- Equability of taxation is only possible, in the view of the revenue authorities, with the aid of automated systems for filing income tax returns:
 - Low-risk taxation cases should preferably be switched to fully automated processing
 - Human resources should be concentrated on the cases where there is a high risk of tax default
- Exclusively automated processes are permitted in certain cases

3.3 Automated Tax Return Filing Processes

- Used (almost exclusively) to date for employee contributions:
 - Income from employment
 - About 24 million cases (Germany-wide)
- Organisation of process in Rhineland-Palatinate:



3.4 Black-Box Audit Procedure



- No further checks
- In more than 60 % of cases

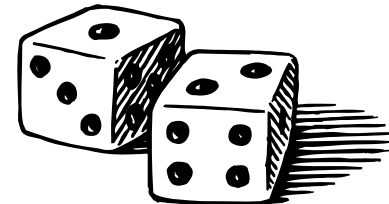
1. Investigation of selected causes of rejection (spot checks) or
2. Investigation of entire case

= Second processing

3.5 Description of Risk / Machine Rejection

- Revenue authorities define case as tax default risk
- Point of reference for identification of tax default risk:
 - Details of taxpayers in tax returns
 - Which data can be machine-evaluated?
 - e.g. Income levels or levels of expenditure eligible for tax relief (e.g. advertising costs)
- Design of risk filter:
 - Predominantly based on thresholds (high expenses = high risk):

- e.g. Journeys to work	> 100 km
Specialist literature	> 2,000 euros
Maintenance of two households	> 10,000 euros
Donations	> 2,000 euros
 - To a lesser extent also plausibility checks:
 - e.g. More journeys to work than working days
- Problem:
 - If the thresholds or plausibility limits are not exceeded then non-deductible expenses can also “slip through the net”
 - Machine acceptance without staff check
 - e.g. Lifestyle costs
- Back-up check (in some 1-2 % of all cases):
 - Random-generated sample for staff checking
 - So that nobody can “feel immune”
 - To check the system



4.1 Review Objectives

Is the equability of taxation (still) guaranteed by the black-box system?

Is the black-box system capable of identifying the risks?

Does the new system have weaknesses?

How can the black-box system be improved?



4.2 Review Methodology

Procedure

- Review shortly before rollout of new system (pilot phase)
- 6,000 income tax cases were audited (of about 700,000 comparable cases in the tax assessment period)
- Cases were selected on a random basis (daily sample)
- The tax cases which were audited had already been processed, finalised and closed

Review approaches / targets

- Risk filter
 - Were the cases which were given machine clearance by the black box really low-risk cases?
 - Were due amounts of tax not assessed because the tax returns were not processed by staff?
- Quality of work
 - What (else) would have needed to be done in the cases processed by staff?
 - Human errors?
 - Insufficient establishment of facts?

4.3 Main Results of Review

Labour-intensive input required to render handwritten tax returns machine-processable!

Essential preparation:

- Correction / addition of codes
- Data input



Cases given machine clearance produced tax shortfalls of 10 million euros (in the year)!

- 15 euros per tax case

Processing errors also occurred in the cases screened out for staff checking!

Human error in every 5th case:

- 28 euros' tax shortfall per case
- Frequent failures with regard to sufficient establishment of facts



Tax shortfalls caused by the (new) black-box system could not be compensated by tax savings in cases processed by staff!

4.4 Risk Management Observations

- There is a risk of tax default in just $\frac{1}{4}$ of cases ($\frac{3}{4}$ of the cases are low-risk):
 - Risk is particularly low in the lower income groups:
 - Minimal risk with incomes < 15,000 euros
 - Risk of approx. 10 % with incomes < 25,000 euros
- The black-box system was not able to pinpoint the high-risk cases:
 - In 70 % of the cases screened out by the black box for staff checking there were no financial repercussions

Reasons:

- Too many rejection criteria have no ramifications in terms of tax
 - More than half of the 230 rejection criteria were fruitless
e.g. Insurance premiums as special expenses
- The 15 “most lucrative” rejection criteria generated 95 % of the extra earnings
 - e.g. Extraordinary charges > 2,500 euros
 - Other advertising costs > 1,000 euros

- Error-prone situations were not detected by the black box

Reason:

- No rejection criterion or insufficiently precise criterion (vague / thresholds too high)
 - e.g. Earnings replacements (unemployment benefit, sick pay, etc.) not screened out
 - Progressivity proviso to be taken into account
 - Expenditure on public transport for journeys to work
 - Extra earnings in many cases already < 2,000 euros

4.5 Changes in Black-Box System



- Revision / amendment of rejection criteria / thresholds / key ratios
 - Examples:
 - Rejection of earnings replacements (progressivity proviso)
 - Rejection of cases where journeys to work were made on more than 290 days
 - Rejection of cases where costs of public transport to work exceed 1,000 euros
 - No further rejection in case of insurance premiums

- Inclusion of comparisons with previous year
 - Screen out for staff processing if there are major discrepancies when compared with data for previous year
 - Screen out for staff processing if a situation is included in the return for the first time, e.g. new arrangement involving maintenance of two households

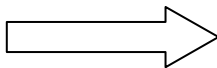
- Tax forms and pre-printed forms have been made easier to understand
 - More key ratios also enable better automated evaluation processes

4.6 Further Development of Automated Assessment Process

- Use of risk management systems in other federal states as well
- Standard rejection criteria now rolled out across Germany with the facility for local customisation
- Problem: a machine process with rigid thresholds is “computable” and leads to “tax-exempt amounts”

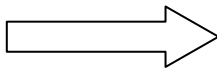
Appraisal

Revenue authorities have not yet attained their objective of concentrating the deployment of their human resources on high-risk cases with potential earnings!



Further improvements are imperative:

- Risk management (refinement of rejection criteria)
- Quality of work



More intelligent grids / links needed with other criteria:

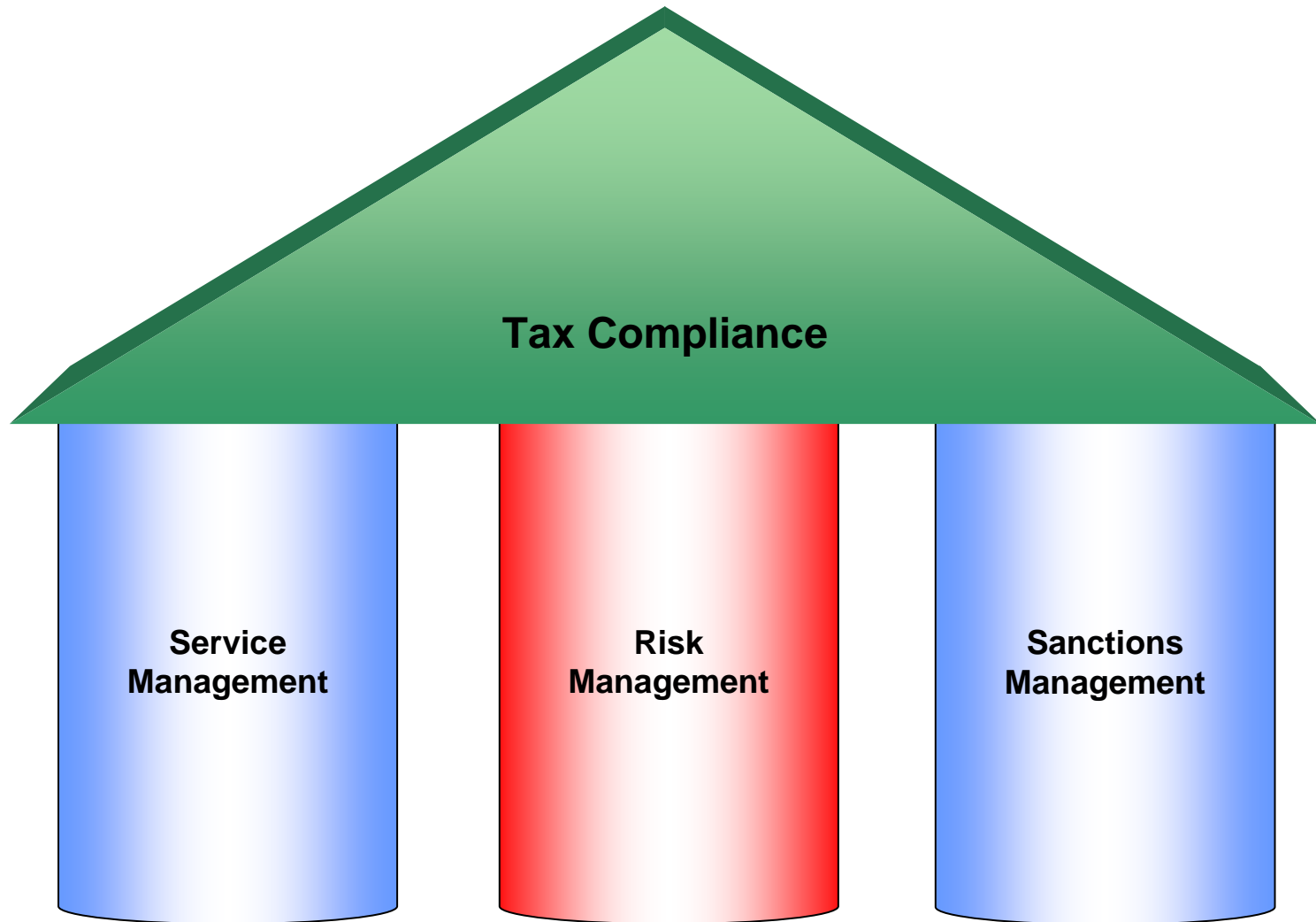
- Better classification in high-risk groups!
- Not just figures!









Excursus

“Alternative Identification of Risk and
Minimisation of Risk through a
Tax Compliance Strategy”

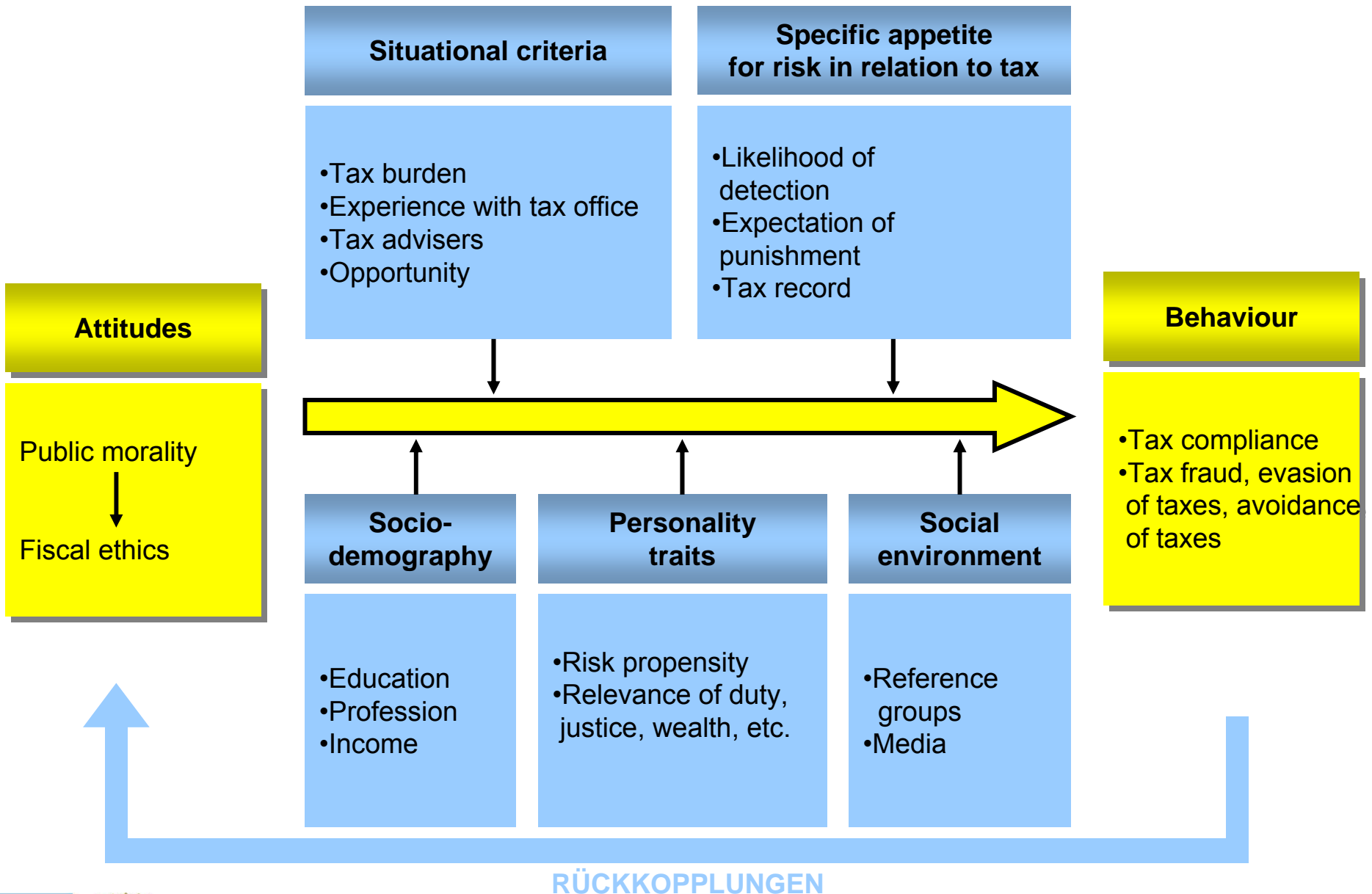
5.1 Tax Compliance - Basics



5.2 Tax Compliance - Questions

-  The *tax compliance* strategy - comprising service, sanctions and risk management - is intended to increase the willingness of taxpayers to cooperate.
-  Risk management: differentiation of *low-risk* and *high-risk* cases.
-  Information problem: there is no certainty about the truth of the statements made by taxpayers.
-  Disclosure habits of taxpayers to be appraised in the *compliance coefficient* using socio-demography and tax record data.
-  There are no confirmed insights to date regarding links between socio-demography and tax evasion, and no verified hypotheses.
-  Empirical research to investigate the influence of socio-demography (and tax record) on tax evasion.

5.3 Taxation Psychology Research Model



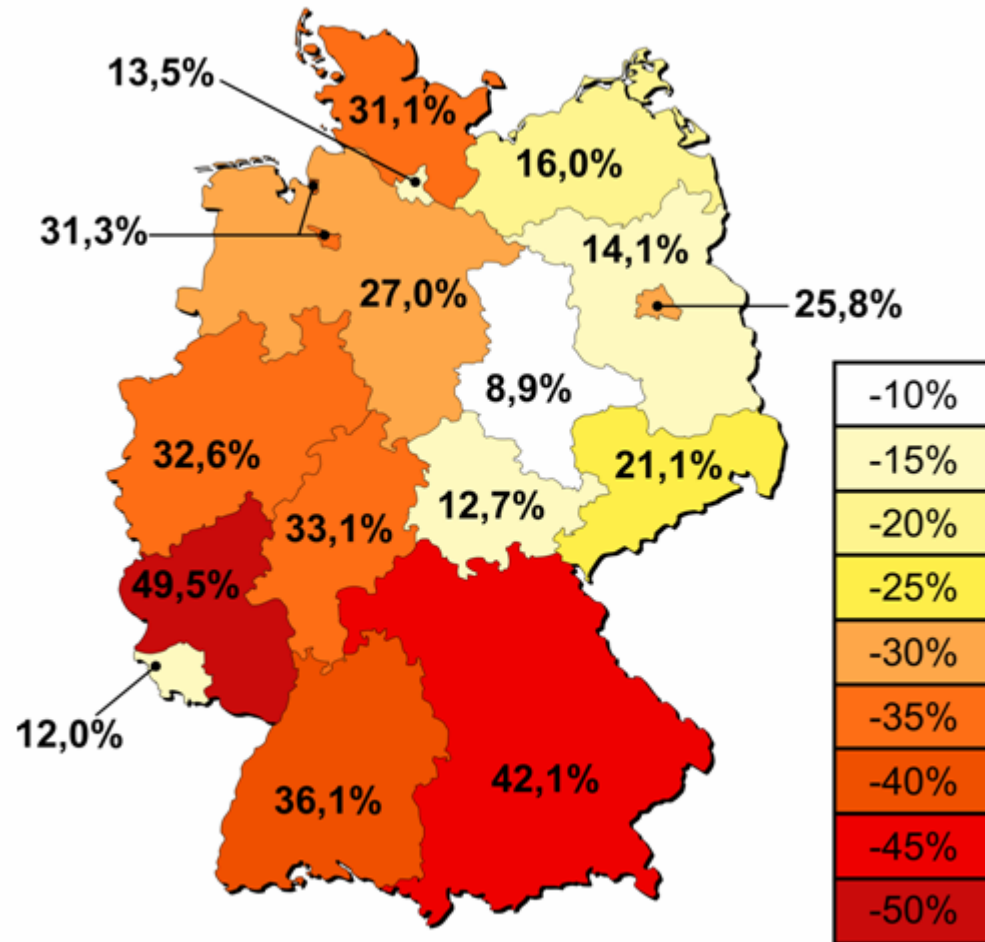
5.4 Socio-Demographic Factors

- **Men are twice as likely as women to evade tax**
- **Tax evasion is more common in middle age**
- **Much more frequent in the west of Germany than in the east**
- **More frequent in the south than the north of western Germany**
- **Tax evasion is more pronounced in rural communities than in towns and cities**
- **Self-employed persons and freelancers show more tendency than most to evade tax**
- **The risk increases significantly with the amount of income above a certain level**
- **Even greater influence in this regard is had by the type or source of income (investors, landlords, self-employed)**
- **Order of influence shown in socio-demographic data:
source of income, level of income, profession, earning status, gender, age, neighbourhood**

5.5 Situational Criteria Relevant to Taxation Psychology

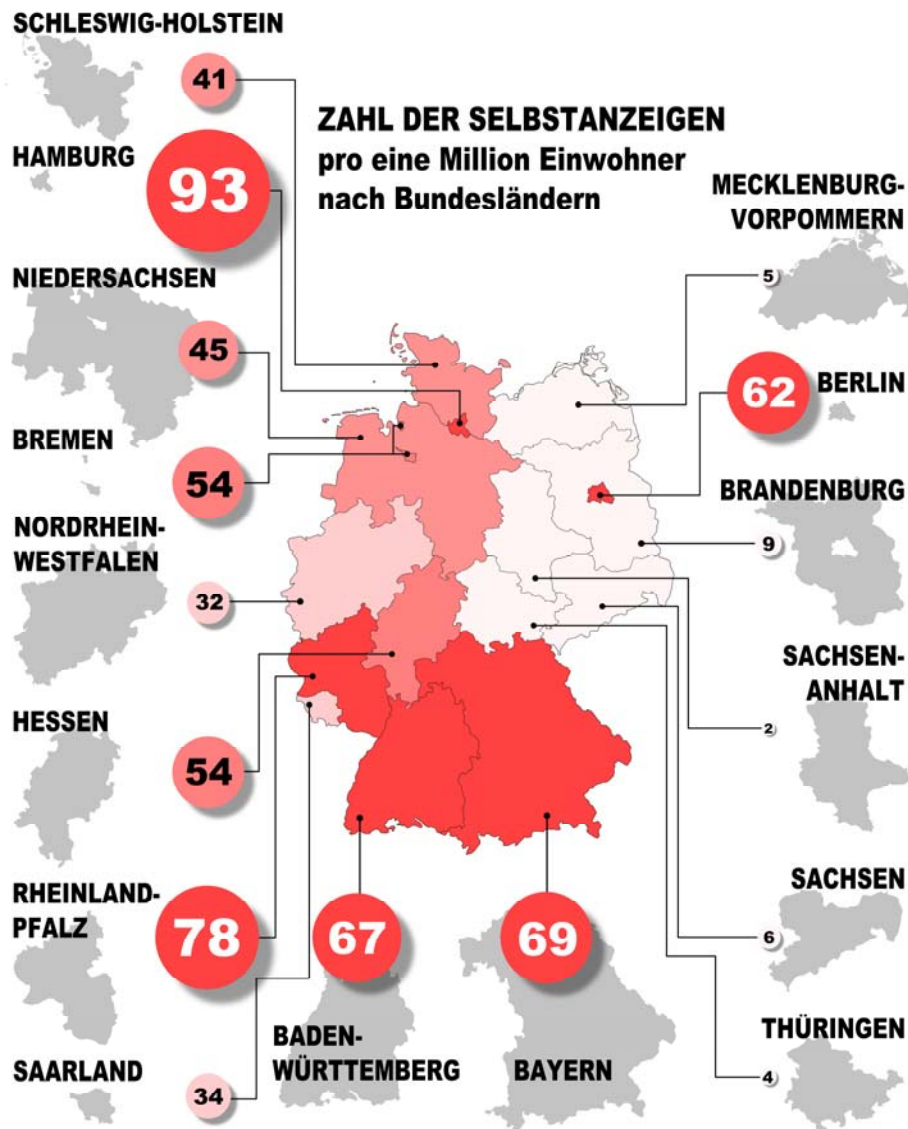
- **As a general principle: greater influence than socio-demographic criteria**
- **Greatest tendency towards tax evasion is found among taxpayers who:**
 - **are late in submitting their tax return**
 - **consult an adviser**
 - **have a negative impression of their tax office or have already had altercations with their tax office**
- **Waste of public money has a greater effect on tax compliance than the evasion of other taxpayers**

5.6 Proportion of Tax Evasion by Federal States





5.7 Amended Returns after Acquisition of CD Containing Tax Data



Quelle: Landesfinanzministerien, Stand: 22.2.2010

Thank you for your attention