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Risk-Based Tax Audits in India and Evolution to Risk Management

Saksham Sharma
Yadavindra Public School Patiala

Abstract: Today's tax administrations lay increased emphasis on self-assessment and voluntary compliance, and they are moving the emphasis of tax enforcement from risk assessment and management to risk assessment and management. This is because (1) it would be inefficient to regularly audit low-risk, complying individuals and (2) no revenue administration can realistically monitor and inspect every taxpayer. This comprehensive and collaborative strategy aims to promote taxpayer compliance by systematically addressing compliance challenges as a component of long-term strategic planning. Indian tax administration (direct taxes) has adopted risk-based auditing utilising a computer-assisted scrutiny method gradually but progressively (CASS). Despite the establishment of CASS, human selection of tax audits has persisted. The revenue administration is a crucial link between the government and its people. Consequently, a trustworthy tax system is necessary for functional governance. Consequently, legislators are just now realising the need to establish legislation that simultaneously encourages corporate development and ensures complete, voluntary tax compliance. At this time, it is neither desired nor feasible to perform a comprehensive audit of every single taxpayer. Consequently, good compliance management is vital for tax administration. To encourage voluntary compliance, i.e., when taxpayers voluntarily comply with their tax duties without interference from tax authorities, it is essential to establish innovative auditing strategies based on risk management. Audits depend primarily on a systematic technique of choosing auditees that identifies and prioritises taxpayers who represent the greatest threat to the government in order to maximise their efficacy. This aids in fostering a more willing attitude of compliance. As was also recently observed, when the government is unable to properly combat tax evaders, it may lead to a range of concerns and problems. In view of the significance of tax compliance, I want to study methods to make it even more efficient. This article examines risk-based audits for tax compliance, concentrating on their definitions, the significance of key terminology, their application, and their effectiveness. In the essay's meatier middle portion, I will argue why such a system would be advantageous for emerging nations such as India, using specific examples from countries such as the Netherlands. In addition, a practical model may be created by researching the tax compliance rules of various nations and then constructing a risk management-based system.

I. INTRODUCTION – KEY PRINCIPLES OF RISK BASED AUDITS

In several studies of tax compliance from the perspective of taxpayers, the usual assumption of predicted utility maximisation is used. [1] If a taxpayer considers that the cost of paying their taxes outweighs the advantages of not paying them, they will not pay them. Therefore, it is the responsibility of the taxpayer to maximise gain while minimising the likelihood of being detected by tax authorities. The tax office must thus be cautious in its enforcement of the law. This fundamental scenario has been expanded upon in several books and articles to incorporate the strategic purpose of tax administration. [2] These studies are based on game theory and use the principal-agent theory with asymmetric information outcomes. [3] The improved models account for the fact that the probability of detection (assuming taxpayers would "naturally" understate their income without any attempt at detection) is not exogenous, but rather depends on the information taxpayers provide to the administration.[4] Within the restrictions of a set budget, the objective of the tax administration should be to maximise predicted tax and penalty revenues after accounting for audit and enforcement expenses. [5] Obviously, the reported income of taxpayers is the product of their own labour. The last phase of the game gives the tax authority with both a taxpayer compliance plan and an audit strategy. [6]

1 Andreoni, J., B. Erard, and J. Feinstein. 1998. “Tax Compliance.” Journal of Economic Literature 36 (2): 818–60
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 TaxUnderreporting in the Tax Compliance Game.” Journal of Development Economics 42 (1): 1–33.
6 Khwaja, Awasthi & Loeprick, Supra N.2, 14

Tax administrations should consider three OECD compliance behaviour criteria. First, management field, business size, financial stability, and human qualities such as gender, age, and degree of education all influence the compliance level of an organisation or industry. [7] Taxpayer compliance is contingent upon a fair tax system. Taxpayers evaluate fairness using three criteria. The total amount of tax due, the taxpayer's position with the tax administration, and the distribution of tax money by the government. [8] If conformity becomes the norm, everyone will feel more pressure to conform. [9] Individual taxpayers are more inclined to comply when infractions are prevalent at the societal level. [10]

The goal of the audit is evident. Audits identify compliance concerns prior to their resolution. Audits encourage compliance by uncovering potential noncompliance and enabling targeted action against certain taxpayer groups.[11] Audits enable the government to evaluate the health of the tax system and monitor tax evasion. Consequently, the whole tax system may be examined. [12] Risk-based audits need the selection and auditing of taxpayers independently. This separation avoids corruption among tax collectors and promotes extortion. [13] The committee's exclusive focus on auditing would aid in the training of more qualified auditor inspectors. As the income of auditors is contingent on the adjustments and penalties they impose, they have a strong incentive to falsify the numbers. When auditors assist with strategy decisions and audits are biased against taxpayers due to mechanical incentives, the audit function loses its raison d'être. [14]

II. RISK-BASED AUDIT SELECTION

Tax administrations around the world focus on taxpayer non-compliance risks.[15] The efficient audit selection strategy identifies taxpayers who likely to be noncompliant, i.e., who have the highest likelihood of yielding large amounts of audit adjustments and penalties.[16] Each taxpayer obtains a score based on their unique features (size, industry, compliance history) and audit data (whatever the selection technique) (whatever the selection strategy). The IRS may use these tactics to develop "profiles" of diverse taxpayers to find lawbreakers. This strategy overcomes random selection's faults while preserving its benefits (intelligence building for tax administration, statistically robust approach) (intelligence building for tax administration, statistically robust approach). [17] This audit selection strategy is favoured by several tax administrations in industrialised nations, as well as transitional and emerging nations. It is costly to invest in trustworthy computer systems and data collection procedures. Such a system would need government assistance for substantial costs. It is also advantageous for future tax administration requirements. Nations in development with limited resources and expertise may suffer.[18]

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III. TAX SYSTEM IN INDIA

India has nearly 30 million taxpayers, calculated according to the data analysis in the year 2007. India follows the basic principle: trust the taxpayers, but verify their claims.[19] So the system that was followed in India was a system of selective introduced in 1987. The selection of auditing remained discretional, giving unfettered power to tax officials, and it has been since then a source of many complaints. However, in the 1990s, the Central Board of Direct Taxes (CBDT) specified criteria for selecting cases for audit in their annual action plans. However, a superior officer still needs to give approval, thus still leaving rooms for discretion and creating room for exceptions. In 2004, the CBDT moved to establish a self-assessment system sing risk-based audits supported by efficient Information Technology. The construction of a nationwide tax office computer network. As part of this network, more than 750 offices in 540 Indian cities and villages were brought online. This was achieved by establishing a centralised computer system for tax return processing. In 2006, businesses were forced to submit their documents electronically.

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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, 2004c
11 Khwaja, Awasthi & Loeprick, Supra N.2, 16
12 ibid
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 Ibid
18 Ibid
19 Ibid, 97

In 2007, the threshold was raised to encompass enterprises with yearly sales above Rs 4 million. Furthermore, Computers are employed for the initial analysis and verification of findings. Annually, the criteria for choosing audit cases are defined by the CBDT. CASS determines the cases to be audited. The CBDT's top staff develops several confidential criteria. In addition, the system will notify you of any very high-ranking tax requests. Simulations Outliers in each parameter are produced using Gaussian distributions, and the data is scored using computer algorithms to evaluate the taxpayers' potential exposure to risk. [20] The CBDT establishes the maximum audit frequency for each indicator, starting with the instances posing the greatest risk and proceeding downward. Annual reporting of investments and costs was allowed. [21] The CASS analyses income tax returns with third-party records of investments and expenditures maintained by banks, the federal reserve bank, and property registrars. The system recognises circumstances based on predetermined criteria.[22] A new direct taxes code was drafted in 2009 and will soon be introduced to Parliament to be passed into law after a nationwide public debate.[23] In the direct taxes code, section 156 specifies the process of selecting a tax return for scrutiny.[24] Section 156(2) defines that the selection of cases for scrutiny "shall be made in accordance with the risk management strategy framed by the Board in this behalf" (India, Ministry of Finance 2009).[25] The section further prescribes a time frame within which the taxpayer must be informed of the fact that his or her case has been selected for scrutiny.[26]

IV. A CASE STUDY OF THE NETHERLANDS – RISK MANAGEMENT STRATEGY

The strategic goal of the Dutch Tax and Customs Administration (DTCA) is compliance, defined as the willingness of taxpayers, either businesses or individuals, to fulfill their tax obligations by reporting relevant facts correctly, on time, and in full.[27] The DTCA maintains a service-oriented respectful approach toward taxpayers.[28] Voluntary compliance is promoted through corrective action and, as a last resort, enforced through the criminal court system (DTCA 2008).[29]

In India, risk-based auditing is used, but in the Netherlands, risk management is recommended. The Tax Administration decides which tools to use in this approach depending on the behaviour of taxpayers and their administrative skills. Risks, including subjective input from taxpayers and objective data from tax returns and other parties, are evaluated and managed after policymakers develop strategies and rank goals. The DTCA provides stakeholders with preventative measures and legal procedures to counteract dangers. Laws, public addresses, services, and site inspections are all examples of preventive measures[30]. Audits, fraud inquiries, and fines are harsh. Modern innovations include horizontal surveillance technology, inter-police communication, and inter-agency coordination. [31] The service desks, contact centres, and prefilled tax returns provided by the DTCA reduce errors and compliance costs. This improves public confidence in the government. Simplifying fiscal legislation increases the accuracy of pre-filled forms and decreases the possibility of human error. To encourage cooperation and transparency, the agency has developed a horizontal monitoring mechanism between governments and businesses. By moving the regulatory burden onto enterprises, the DTCA delivers a valuable service. They promote open communication between companies and financial advisers to prevent the incidence of tax return issues. Instead of being revealed by audits, tax concerns are prepared for in advance. Additionally, minor offences and penalties are prone to repression. The taxpaying people and the corporate environment both gain from this. This results in an increase in administrative costs. Although it is preferred to assemble risk information in a single location, it is occasionally necessary to do so at the regional or local level. In addition to databases and analytics, monitoring the environment is a vital component of risk management. [32] Annual reports and tax returns (regional comparisons of assets, comparisons of turnover ratio), business development data, 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 find new entrepreneurs, professional judgement, and the intuition of regional tax auditors are all valuable sources of information. [33]

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20 Ibid, 98
21 Ibid, 98
22 Ibid, 98
23 Khwaja, Awasthi & Loeprick, Supra N.2, 99
24 Ibid
25 Ibid
26 Ibid
27 Jon Hornstra, Khwaja, Awasthi & Loeprick, Supra N.2, 83
28 Ibid
29 Ibid
30 Ibid
31 Ibid
32 Supra N. 24, 88
33 Ibid

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V. CONCLUSION

On paper, India's system seems to be ideal. Because the selection criteria for tax audits are confidential and based on the tax department's internal system, the system is susceptible to many loopholes, such as taxing and enforcing based on the choices of tax auditors. Although tax officers no longer have unfettered power, they nevertheless have considerable discretion in conducting tax audits. The police only care about themselves, not the well of the nation. Genuine taxpayers and national growth are harmed by this mentality. India criminalises tax evasion despite the fact that they should be promoting tax compliance. The department of India prioritises revenue collection above tax compliance. In this context, it is not the laws itself that is flawed, but rather its implementation and people's mindsets. The government must establish an efficient training centre for future tax auditors, with two distinct departments responsible for choosing auditees and conducting the plan.

Due to inefficiencies and delays, India's tax system is complex, unpleasant, and delivers little benefits compared to that of the Netherlands. The Netherlands are underpopulated, yet their unique cost-cutting strategies allow them to succeed. The tax system in India is inefficient and costly. Tax litigation involving Satyam and Vodafone's global holdings are examples. In both instances, the tax office spent a substantial amount on legislation without reaping any benefits. Implementation may be more successful with risk management than with tax legislation that only collects revenue. Clear vision, goals, and strategy; governmental commitment and support; a central risk management department accountable for identifying risks, providing assessments, gathering risk-related information, including random sample results; and focusing on nationwide risks. Through audits, a nationwide compliance survey, or both, comprehend the behaviour of taxpayers. To create a better, more effective tax system, it is crucial to get knowledge about new compliance-enhancing technologies, such as services, horizontal monitoring, legislative solutions, and communication with enforcement.[34]

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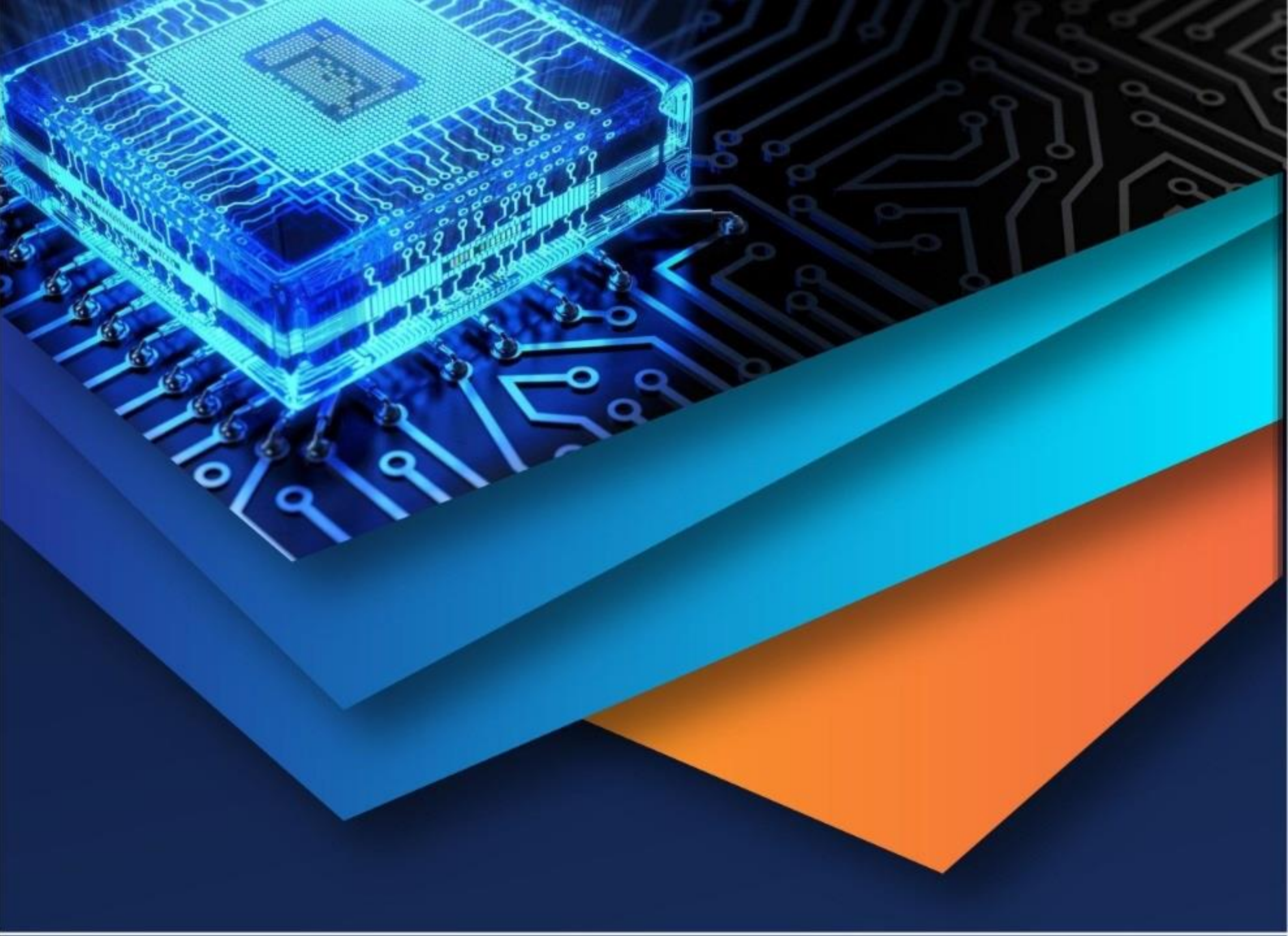
34 Supra N. 24, 89



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