

# **CHAPTER- I**

## **INTRODUCTION**

### **1.1 Background of the Study**

The tendency of welfare state in the present day world of twenty- first century is increasing rapidly. A welfare state has many duties and responsibilities towards its sovereign principal. The government tries to maximize the welfare of the people through Development and efficient allocation of resources. Till 1960's the economic development was focused on Economic growth. But afterwards social issues such as Poverty alleviation and equitable distribution of income and wealth replaced the issue of growth. In the 1980's, the concept of sustainable development, reflecting increasing concern about environment, has emerged.

Economic growth and stabilization are the main objectives of any economy. Economic growth is still the first priority of developing countries. They have to accelerate their economic growth rates, eradicate absolute poverty, reduce inequality in income distribution and create more employment opportunities.

The economic growth of world economy was 4.9 percent in 2007, whereas economy of our close neighbours China and India grew by 11.4 and 9.2 percent respectively. Our GDP growth rate (2.5 per cent) was lowest in the SAARC region.

Instruments of government intervention to the public economy are revenue and expenditure policies. Government needs adequate resources for successful implementation of all these development activities in the country. Nepal is no exception to the category of welfare state. It has to perform all the duties of a welfare state. Moreover, there was serious insurgency in the country for several years. On one hand, the current expenditure is rapidly increasing, as government has to spend a lot of fund for peace process. On the other hand, the development expenditure is decreasing day by day but it may increase after the final settlement of peace process. In order to meet the growing need of public expenditure,

government has to generate resources from various sources. Government gets revenue from internal and external sources.

Internal source consists of internal revenue and internal loan and bilateral and multilateral loan and grants are the components of external source. The overall ratio of foreign loan to GDP is almost 60 percent and the ratio of Nepalese revenue to foreign loan has reached to around 2500 percentages in the year 2007. It is not so good to depend heavily on external sources for it may become harmful in the long run.

The study of Nepalese budget shows that there is wide resource gap. For the fulfillment of resource gap, deficit financing has no scope for it is already greater than 5 percent of GDP. So, it is not an effective instrument in the long run. It entails vicious results of inflation in the economy. So, Nepal has to mobilize maximum internal resources.

Internal resources include tax, non- tax revenue and internal borrowing. Internal borrowing is not effective as it discourages the private sector to spend. The optimum limit for internal borrowing is less than one percentage of GDP. It has already exceeded in Nepalese context. So, there is no scope for internal borrowing further. The overdraft facility from NRB is legislatively limited. Government cannot trespass the limit; however, it is violated in some occasions. There is increasing tendency of trade but not aid and low rate of tax in the context of globalization. So, Nepal has to resort to its own internal resources especially revenue from production, consumption and non-tax sources.

After the restoration of democracy in 1990, GON has adopted liberalization in economic activity that has been creating more opportunities as well as facing challenges. In the context of liberalization and globalization of the world economies, many Governments have opened new investment avenues to foreign investors; in turn, Government has improved tax systems and procedures. In order to meet these new Challenges and to simplify tax administration, Government of Nepal amended the tax laws with new provisions and procedures to assist the taxpayers in complying with the self-assessment process. One of these tax

improvements occurred when GON introduced Self-Assessment in Taxation through amendment to the Income Tax Act in 1993. This amendment is a milestone in the history of tax administration in Nepal. Under this system, taxpayers are given responsibility to assess income tax liability on the basis of their income in prescribed form and manner. This system is common in most developed countries. The objective of introducing self assessment systems were to:

- ) Encourage taxpayers to pay tax with dignity;
- ) Promote the filing of tax returns on time
- ) Collect tax in a timely fashions; and
- ) Reduce the cost of tax administration.

Keeping in view the necessity of adequate resource mobilization for meeting the increasing need of fund for the economic development of the country, GON has introduced VAT as a major part of tax reforms in November 1997. VAT is a broad-based consumption tax. VAT is applied to the difference between a business's sales of goods and services and its purchases of goods and services, therefore taxing the value added by each business. Unlike retail sales taxes (RST), VAT is collected at all stages of production and distribution. VAT is also based on self-assessment system.

In 2002, GON has introduced completely new income tax act, which advocates self-assessment system and merged two departments, i.e. VAT & Income tax, to support its tax reform program. The new department, Inland Revenue Department, looks after sources of all internal revenue; they are VAT, Income tax, Land rent tax, Interest tax and Excise duty.

The vision of IRD is “to develop globally compatible taxpayer friendly tax administration.” (Annual report of IRD)

The purpose and an overriding mission of IRD is to mobilize maximum internal revenue through the establishment of fairer, efficient, effective, modern & economic tax administration. IRD has the objectives of increasing revenue by

providing effective service to the taxpayers through fair and transparent administration.

IRD has adopted following policies to attain the above-mentioned mission and objectives.

- Broadening the tax base
- Developing VAT as a major source of revenue
- Developing account based tax system
- Increase voluntary compliance and self assessment tax system
- Making transparent, simple and taxpayer friendly tax administration

## **1.2 Statement of the Problem**

As the government revenue is growing at a lesser rate than the growth in the expenditure, the gap between revenue and expenditure is increasingly widening. In 2004/05, the revenue to GDP ratio was 11.1 per cent, which increased by 1 percent point and reached to 12.1 percent in 2005/06. On the other hand the ratio of government expenditure to GDP increased by 1.3 percent point and reached 18.4 percent in fiscal year 2005/06. This shows that the ratio of government expenditure has been higher than that for revenue to GDP.

Of the total revenue collection in 2005/06, the share of tax revenue was 81.1 percent whereas share of non-tax revenue was 18.9 percent. However, the tax revenue increased by encouraging 23.8 percent in 2005/06 in comparison to 13.1 percent in 2004/05, the need of excessive public expenditure for peace process and to fulfill the development objective, compels the government to increase the tax revenue which is considered as more reliable source for the government expenditure.

In above circumstances, tax audit can play a crucial role to increase tax revenue.

Tax audit is the pillar of Self-Assessment System. A tax audit is an examination of whether a taxpayer has correctly assessed and reported their tax liability and fulfilled other obligations.

It is the power centre and the determining force; tax audit will determine the success of the system in increasing the rate of voluntary tax compliance. Tax audit has been around since the commencement of the Self – Assessment System.

The audit program of IRD should perform a number of important roles that, effectively carried out, can make a significant contribution to improved administration of the tax system. These roles are

- ) Promote voluntary compliance
- ) Detect non-compliance at the individual taxpayer level
- ) Gather information on the “health” of the tax system (including patterns of taxpayers’ compliance behavior)
- ) Gather intelligence
- ) Educate taxpayers
- ) Identify areas of the law that require clarification

Considering above objectives and roles, IRD has been giving top priority on audit and investigation. Is it functioning effectively? This is the one of the important issue in tax administration in Nepal.

### **1.3 Objectives of the Study**

The study focus to evaluate the present performance of audit program of IRD and to propose recommendations for reform. The objectives of the study were:

- a. To examine the self assessment function as per VAT and Income Tax act and rules.
- b. To evaluate the status of management assessment system as per VAT and Income Tax act and rules.
- c. To analyze the problems and challenges faced by tax officials and taxpayers during the audit.
- d. To suggest and recommend on the basis of major findings.

### **1.4 Significance of the Study**

“Existing situation of tax leakages in Nepal is very alarming. The estimated evasion is more than 40 percent of taxable capacity. The survey conducted jointly by a donor agency and FNCCI showed annual smuggling of NRs. 33.50 billion for

the FY 2003-004. This is about 42.55 percent of the official trade of NRs 78.74 billions. The average customs rate for the year is 10.7 percent. Applying this rate, the amount of customs revenue leakage is estimated to be about NRs. 3.58 billion. This figure is about 25 percent of the customs revenue collected during the year. Similarly the loss in value added tax from the same smuggling is about NRs. 3.71 billion. The amount is about 42 percent of the VAT collected from import during the year. Assuming the same level of smuggling from Tibetan border and Tribhuvan International Customs point revenue leakages would be about NRs.330 millions and NRs.120 millions respectively. The smuggling to and pro the survey is assumed to have remained in the same level. Because no concrete policy and administrative actions has been taken since the time by the Authorities. (Ghimire, 2006: 26)

Even if a tax administration is very effective in registering taxpayers and detecting stop filers or delinquent taxpayers the administration's overall effectiveness will be low if auditing is not effective in discouraging evasion. (Baer and Silvani, 1997:65)

Audit and investigation function of IRD can play a crucial role in this context to meet the objectives of IRD as well as economic objective of GON.

### **1.5 Scope of the Study**

The study didn't look into every aspect of tax auditing as this concept covers audit programs of Department of Customs and other institutions; it was concentrated on the audit program of IRD only. But it has tried to examine the effectiveness of tax audit and impact of audit program on taxpayer compliance.

### **1.6 Limitations of the Study**

The main limitations of this study were the following:

- a) Limited time to collect data.
- b) The study based on primary and secondary data collected from different sources.

- c) The study is simply a partial study for the fulfillment of MBS degree. So the study cannot cover all the dimension of the subject matter and time period is also limited.

### **1.7 Organization of the Study**

This thesis has organized in five chapters. The first chapter is about introduction. It includes General Background, Statement of Problem, Importance of Study, Objectives of Study, Scope of study, Research methodology, Limitations of the study, Organization of Study

The second chapter is about Conceptual Framework and Review of Literature. In Literature Review, review of thesis, books, research reports and articles are done which are used as guideline for preparing this thesis.

The third chapter is on Research Methodology which includes research design, nature and source of data, data and information collection procedure, data processing and analysis procedure.

The fourth chapter is Presentation and Analysis of Data. This chapter also reveals the major findings of the study. In which the major findings from the secondary data are organized in a systematic way.

The fifth chapter is Summary, Conclusion and Recommendation which summarizes the thesis, draws the conclusion and provides the recommendation measures for the improvement of existing situation.

## **CHAPTER- II**

### **REVIEW OF LITERATURE**

Review of literatures on this research consists of two parts, i.e. first part describes theoretical aspect of tax audit and effectiveness and later part explains available and related research on this topic.

#### **2.1. Theoretical Framework**

##### **2.1.1 Meaning of Audit**

“Auditing is a systematic examination of financial statements, records and related operations to determine adherence to generally accepted accounting principle, management principles or stated requirements.”(Schlosser, 1999:98)

The word audit is derived from Latin word 'Audire' which means, to hear, in ancient times; whenever the owner of a business suspected fraud, they appointed certain persons to check the accounts. When Italian, Luca Pacioli published double entry book keeping system for the first time in 1494 A.D., He clearly described the duties and responsibilities of an auditor. Since then there has been lots of changes in the scope and definition, duties and responsibilities of on auditor.

The objective of audit at that time was to see whether accounting party had properly accounted for the receipts and payments of cash or not. The principal objectives of audit in those days was to see "Whether an account exhibits a true and fair view of the state of affairs of the organization or not".

According to general guidelines on internal auditing issued by the ICAI, “Auditing is defined as a systematic and independent examination of data, statements, records, operations and performances of an enterprise for a stated purpose. In any auditing situation, the auditor perceives and recognizes the propositions before him for examination, collects evidence, evaluates the same and on this basis formulates his judgment which is communicated through his audit report.”

From the above ideas, we can describe that the auditor not only examines the arithmetical accuracy of accounts but also finds out whether the transactions are entered correctly or not and to find out inspecting, comparing, checking, reviewing, scrutinizing the vouchers supporting the transactions in the books of account and examining the correspondence. Audit is an examination and verification carried out by an outside agency of a taxpayer's books and accounts and or the general accuracy of returns and declarations either as a routine operation or where evasion is suspected. In many countries, large business organization particularly those with public membership were by law to appoint accountants. Auditors to prepare and certify the annual returns of tax purpose, tax authorities carry out audits for routine checking or for investigating suspected his-administrative or fraud.

The objectives of business audit are whether the financial statement represents a true and fair state of the affairs of a concern or not, so that when verifies the account and statement then the auditors discovers errors and frauds. So the main objectives of auditing are detection/prevention of errors and frauds.

## **2.2 Taxation Concept**

Taxation is the biggest source of public revenue of the modern governments. In a democratic setup taxation is responsible for shaping the political activities of the government that are aimed at equity growth and stabilization. The term 'tax' has been used since a very long time.

The OECD working definition of tax is "a compulsory payment to the government." Findlay Shirras defines "Taxes are compulsory contributions to public authorities to meet the general expenses of the government which have been incurred for the public good and without reference to special benefits".

The distinction between direct and indirect tax is based on the impact and incidence of tax. Direct tax is the personal tax. If the impact and incidence is borne by the same person on whom it is legally imposed and if there is no possibility of shifting, it is called direct tax. Examples are income tax, profit tax, interest tax, dividend tax, property tax. On the other hand, indirect tax is commodity-based tax.

If any tax is legally imposed on a person but the incidence of the tax is borne by another person through backward and forward shifting process, it is called indirect tax. Value added tax (VAT), custom duty and excise duty are some examples of indirect tax.

## **2.2.1 Income Taxation**

### **2.2.1.1 Income Taxation in the International Context**

The history of income tax is full of the story of wars, confrontation and resistance. Great Britain was the first country in the world to introduce successful income tax in 1799 to finance wars with France. In U.S.A. the first federal income tax was imposed in 1862 to finance civil war expenditures. Several German states introduced income tax during 1840. After the Prussian reforms in 1891, the income tax was used as effective fiscal instrument in these states. Italy adopted an income tax in 1844 as one of the first product of its unification. It was not until 1925 that a nation wide tax on total family income was imposed with graduated rates. In France, the efforts were begun to enact income tax in 1870; the income tax bill was enacted as an emergency measures two weeks before when it began in 1914. But it was another 3 years before a permanent income tax system was adopted.

After World War I, the income tax became an important source of tax revenue in many developing countries. By 1939 it had made an appearance in a number of developing nations also. In India, income tax was introduced in 1860, which was discontinued after a few years. It was reintroduced in 1886 on the permanent basis.

Income tax developed rather slowly with many ups and downs. The growth in revenue needs, particularly during the wars and national emergencies, and increasing acceptance of the fiscal powers of the government gave impetus to the income tax movement. Development of Markets, Monetization of the economy, and widespread use of banking facilities, adequate maintenance of records and improved standards of tax administration facilitated the introduction and establishment of this tax.

### **2.2.1.2 Taxation in Nepal**

Taxation has been one of the major sources of government revenue from ancient time; however, reliable records and data about taxation of that time are not available. Taxes were then levied on the merchants, travelers and farmers in the form of cash, kind or labor. On some occasion's gold and agriculture products were also paid as taxes, but the nature of these taxes was temporary.

In the Lichhavi period also, tax was the main source of revenue. At that time taxes were known as "Trikar" which means three kinds of taxes. They were "Bhaga", "Bhog" and "kara". Among them, the Bhaga tax was levied on agriculture, the Kara tax was on business income and Bhoga was on animals. Irrigation tax and religious monuments preservation taxes were also existed in the reign of king Ansubarma of Nepal.

During the period of unification, the major sources of revenue in Nepal were land and homestead taxes, monopolies customs, transit and market duties, mines and mints, and the export of forest produce, birth, animals and various levies and fines, maximization of revenue was the main objective of the tax policies during that period. Local administrators were directed "to take whatever is paid willingly by the people". The taxes were usually collected at three levels.

- a) Royal Palace: To finance occasional and ceremonial needs. The taxes were broad based and progressive.
- b) Government: To finance administrative, military and other purposes assessed on official functionaries, occupational groups and other people.
- c) Local: Perquisites of local officials, functionaries and medicant.

At that time tax was collected on the contract basis. In some parts of terai region, tax was collected at specific rates on jewelry, textiles, falcons, horses, elephants, homespun cloth, yarn, blankets, borax, was, copper, iron, paper, tobacco, herbs, drugs, cotton, salt, yak's tail, sheep and goats. Forest revenue was derived by leaving duties on timber exports also.

The various taxes levied during that period were narrow in base and were imposed primarily in occupations and economic activities, not on income or property. The system of direct taxation was very much confined to land tax and special levies like "darshan-bhet", "salami", "Walak". There was no taxation of income in the modern sense of income tax.

#### **2.2.1.2.1 Taxation in Rana Period (1846-1950)**

During the 104 years oligarchic rule of Rana family in Nepal prior to 1951, the imposition and collection of taxes was done according to the will and whim of the then ruling Rana prime minister. Income and expenditure of the state were not made public. Budget was never framed during the Rana regime. There was no difference between the income of the state and the income of the then prime minister.

The major sources of revenue at that time were land tax, custom and excise duties in the form of lump sum contracts, royalties on felling of trees, royalty on supply of porters and soldiers, entertainment tax, and a few other minor taxes. There was no direct tax in the country except land tax collected on a contractual basis, and "salami" which the government employees had to pay out of their salaries at a very small percentage. Since most of the revenue in Rana period was collected through contracts, no need was felt for the development of effective tax administration system.

The Rana rule was done away in 1951. After the establishment of democracy in the country in 1951, the rule of government has changed, since then government was enforced to implement development activities besides performing the regular functions. The then government tried to generate more revenue by imposing different taxes to implement development works properly.

#### **2.2.1.3 Development of Income Tax in Nepal**

The history of income tax in Nepal is not very long. It was first introduced in the fiscal year 1959/60 under the name of "Business Profit and Remuneration Tax".

The business income and remuneration were subject to tax under the business profit and remuneration tax act 1960 and the rules made there under.

#### **2.2.1.3.1 Business Profit and Remuneration Tax Act 1960 (2017 BS)**

The finance act 1960 made provision for the taxation of business profit and remuneration. The king issued an ordinance to collect this tax. In 1960, the then parliament enacted "Business profit and remuneration tax act 1960 (2017) consisting of 22 sections.

The salient features of business profit and Remuneration Act 1960 were as follows:

- (1) Only remuneration and business profit was subject to tax, deductions were not specified for the purpose of calculating the taxable income.
- (2) Tax on remuneration was to be deducted at source.
- (3) The basis for calculating the tax liability for remuneration was the income of the current year, and for business profit it was the profit of the preceding fiscal year.
- (4) In case of default, fines upto RS. 5000 were prescribed.
- (5) The tax officer was empowered to assess tax on a best judgment estimate where tax return was not filled or a false return was filled.
- (6) The taxpayer was provided the right to appeal against the tax assessment to local "Bada Hakim or magistrate. There after, appeal could be lodged at revenue court accompanying security deposit or guarantee for the amount of tax payable.
- (7) Provision of 25 percentages and 50 percentages rebate on the profits from industries and small industries respectively.

From the experience of three years, it was felt that the business profit and remuneration tax Act was very narrow and vague in tax base. Hence, it was replaced by Nepal income tax act 1962 (2019).

#### **2.2.1.3.2 Income Tax Act 1962 (2019)**

This Act was enacted not only for the purpose of raising government revenue but also to reduce income inequality with social justice and to create tax-paying habit

of the taxpayers. It had 29 sections compared to 22 sections of the previous act. It was amended in 1972 (2029). The additional features of this amended act were as follows.

- (1) Income was defined as all kinds of income including income derived from business, remuneration, profession and occupation, house and land rent, investment in cash or kind, agriculture, insurance business, agency and any other source.
- (2) The personal as well as residential status of the taxpayer for tax purpose was defined.
- (3) The basis was specified for assessing tax on the best judgment estimate of the tax officer.
- (4) The Act granted power to constitute net income assessment committee.
- (5) Provision was made for payment of tax in installment as well as advance payment of tax.
- (6) Provision was made for the assessment of tax as well as rectification of arithmetical errors.
- (7) Provision was made for the exemption of income tax from new industries for a period of ten years.
- (8) Carry forward of losses was allowed for a period of two year.
- (9) The income tax assessment and collection along with the method of calculating net income were specified.
- (10) Agriculture income was brought under the income tax net though frequent exemption of it due to heavy political pressure.

The act remained law till 1972, however, the dire need was felt to consolidate and amend the existing income tax law in tune with the changes in socio-economic environmental milieu of the country.

#### **2.2.1.3.3 Income Tax Act 1974 (2031)**

The income tax act 1974 was the 3rd law relating to income tax administration in Nepal. It had 60 sections; its basic has been derived from the income tax act 1962.

The income tax act 1974 was amended for eight times. Some of the silent points of this act, as amended, are as follows:

- (1) It has clarified certain definitions especially relating to tax, tax payer, gross income, net income, personal status of the tax payer, assessment of tax, philanthropic work, firm, company, family, loss, non-resident tax payers .
- (2) Sources of income were classified into five categories: (a) Agriculture, (b) Industry, trade, profession or occupation. (c) Remuneration, (d) house rent and compound rents and (e) other sources.
- (3) The eighth amendment of this act made provision of self-assessment of tax for the first time and empowered tax officer to make final assessment in case of any mistake; or lower assessment of tax.
- (4) Carry forward of losses was allowed for three years.
- (5) Deduction was allowed for life insurance premium.
- (6) This act had exempted certain type of income such as income of guthi, income of local bodies VDC, Municipality.
- (7) The taxpayer had to register their industry, business, profession or occupation in tax office before starting the job.
- (8) The process of assessment, reassessment, and advance payment of tax, deduction of tax at source and refund of tax had been specified.
- (9) The punishment limit to persons violating laws and regulations was up to RS. 10,000.
- (10) Taxpayers were required to keep accounts and records for their sources of income and preserve these records for a period of six years.

#### **2.2.1.3.4 Income Tax Act 2002 (2058)**

This act is in practice since 19/12/2058 BS replacing the then existing income tax acts 1974. There are various up-to-date provisions in this act. They are:

1. Classification of sources of income into 3 classes. (I) Business (ii) employment (iii) investment
2. Definition of income as "A person's income from any employment, business, investment or in accordance with this act. It includes all kind of income received for the provision of labor or capital or both in whatever from or nature in the taxable income.
3. Provision of natural person or couple for husband and wife.
4. The act has granted the rights and secrecy for taxpayers.

5. Offence is divided into two parts (I) civil offence and (ii) criminal offence. So is the penalty. The tax officer can levy only charges and interest while the court levies penalties and imprisonment.
6. The rate of income tax is specified in the act itself for the first time, which used to be determined, by the finance acts in the past.
7. A person is defined as a resident whose place of abode is in Nepal and who is present in Nepal at any time or who stays in Nepal for 183 days or more within the income assessment year or who is an employee of GON posted abroad during the income year.
8. There is provision of deduction related to overhead cost while calculating assessable income from business and investment.
9. Government allowances to under privileged persons (such as widows, elderly citizens or disabled citizens) and gift, bequest, inheritance, scholarship, income of foreign officials, government bodies and non-profit making organizations have been exempted from the income tax. Income of a person privileged under unilateral or multilateral treaty, an agriculture income, and income of co-operative societies based on agriculture products and dividends of such society are also exempted from income tax.
10. There are limited exemptions as compared to previous acts.
11. A resident person may claim a foreign tax credit to the extent of average Nepalese income tax rate with respect to person's taxable income for the year.
12. Resident individuals and domestic companies are taxed on worldwide income basis whereas non-resident individuals and foreign companies are taxed on source income basis only.
13. Company is separated from its shareholders. The bonus share, loans, and advances to directors and shareholders, distribution made on liquidation. are also taxed.
14. Approved retirement fund is free from income tax.
15. Tax on capital gain: Business capital gains are taxed as an ordinary income whereas gains from non-business assets such as land and building, securities are taxed at a flat rate of 15 percent.
16. The act has adopted global income tax principle and has brought all sources of income into the tax net and has treated in the equal manner.

17. The act has adopted a pooled system of depreciation in which assets are broadly classified into five categories. The depreciation rates are 5percentages, 25percentages, 20percentages, 15percentages for class A, B, C and D respectively which are based on diminishing balance method and that of class E, the rate is based on straight - line method.
18. There is provision of medical tax credit under which resident individual may claim up to 15percentages of approved medical costs.
19. The main feature of this act is self-assessment and every assessment is treated as self-assessment. Presumptive tax is limited to the small taxpayers whose annual turnover is up to RS. 1.5 million and taxable income is up to RS. 150,000 and the lump sum tax is RS. 5000, 2000 and 1500 for metropolitan/ sub-metropolitan city, municipality and village development committee area respectively.
20. The act has made the provision of administrative review to correct the administrative mistakes effectively by taking appropriate decision within 90 days of the submission of objection to the director general of the IRD. If the department does not give its decision within the given time limit, the taxpayer can appeal to the revenue tribunal.
21. The main feature of this act is self-assessment and every assessment is treated as self-assessment.

### **2.2.2 VAT in Nepal**

Sales tax was criticized by cumulative system, as it was consumption oriented and one-sided, not neutral in saving and investment lack of credit system. Traditional income and sales tax had met only public regular expenditure and the new value added tax providence, buoyant revenue base, typically yielding more than initial estimates of revenue in various countries such as Korea, New Zealand, . The main asset in importance value added tax system not only increases the taxation use but also the revenue collection in rational way.

Value Added Tax (VAT) is an indirect tax on consumption that is assessed on the increased value of goods at each point in the chain of production and distribution, from the raw material stage to final consumption. It is levied on the difference

between the sale prices of the goods or services (outputs) to which the tax is applied and the cost of goods and services (inputs) bought in for use in its production.

VAT was introduced in Nepal in November 16, 1997 in replacement of four then taxes: Sales Tax, Entertainment Tax, Hotel Tax and Contract Tax. For the first time, Eighth Plan (1992/93-1996/97) announced a policy of adopting VAT. Prior to this, the idea of a VAT appeared in a few articles and in the IMF mission reports in the 1980s. Ultimately, although it took a little bit longer time than mentioned in the Eighth Plan to make enough study and discussion before implementing it, VAT was successfully implemented in 1997.

To implement VAT, there are separate act and rule: Value Added Tax Act, 1996 and Value Added Tax Rules, 1997. Although there will be some changes in this act and rules every year by Annual Financial Act, the basic principles and provisions are the same from the very beginning.

At the beginning, then Sales Department was changed to VAT Department to implement VAT in Nepal. But later, in 2001, Income Tax Department and VAT Department were merged to a single one named Inland Revenue Department. Now, under this department, there are 22 field offices to administer VAT along with income tax and excise duty.

### **2.2.2.1 Basic Provision on VAT**

#### **2.2.2.1.1 Registration**

According to the Nepalese VAT Act and Rules, any individual, partnership, company or whatever who wishing to engage into a taxable (VAT-able) transaction shall apply to a tax officer in the prescribed form for registration before beginning to engage in such transactions and tax officer shall register those individual under VAT system. After registering, taxpayer will be assigned a Permanent Account Number (PAN) or commonly known as Tax Payer's Identification Number that consists of 9 digit numerals throughout the country.

There are two types of registration under VAT system:

- (1) Compulsory Registration; and
- (2) Voluntary Registration.

Anyone having annual business transaction of taxable goods and services of more than or equal to the threshold level (Rs. 2 million) are subject to compulsory registration. Furthermore, person doing given business and within the prescribed area must register under compulsory registration system. If the annual turnover of taxable goods and services is less than the threshold level, the person should not need to register under the VAT system, but still they may register their business under voluntary registration system. However, any business who import more than NRs.10 thousands at a time must register.

#### **2.2.2.1.2 Scope of VAT**

VAT is based on the destination principle. It is levied on the goods and services where the place of supply is in Nepal and importation of goods and services into Nepal. Exports of goods and services are zero-rated. This means that the tax base is domestic consumption.

VAT is broad-based tax, which applies to all business turnovers through to the retail stages, with a few exceptions. It is levied on a large number of goods and services other than those specifically exempt by law, particularly on administrative and social grounds. Exempted goods and services are mentioned by VAT act, which can be changed by the government by Financial Act and does not require parliamentary approval.

Under exempted category, there are such a commodities comprising of natural and unprocessed products in unorganized sector, basic agricultural products, goods of basic needs, live animals and animal products, medicines, medical and health services, educational services, books, newspapers, artistic and cultural goods and services, transportation services.

### **2.2.2.1.3 How is it Charged?**

The VAT due on any sale is a percentage of the sale price but from this the taxable person is entitled to deduct all the tax already paid at the preceding stage. Therefore, double taxation is avoided and tax is paid only on the value added at each stage of production and distribution. In this way, as the final price of the product is equal to the sum of the values added at each preceding stage, the final VAT paid is made up of the sum of the VAT paid at each stage.

Registered VAT traders who are given a number called PAN (Permanent Account Number) have to show this number to charge VAT from the customers. The customer, if he is a registered trader, knows how much he can deduct in turn and the consumer knows how much tax he has paid on the final product. In this way the correct VAT is paid in stages and to a degree the system is self-policing.

### **2.2.2.1.4 Input Tax Credit System**

All the registered taxpayers are allowed to claim credit of input tax that is paid on the purchase of inputs/supplies from registered suppliers irrespective of when these will be utilized/sold/exported. Input tax paid on purchase of capital goods will also be available to claim credit by the taxpayers. So, taxpayers can adjust such input tax paid on trading or capital goods with the tax collection on sales. If the tax credit exceeds the tax payable on sales in a month, the excess credit can be carried over for the next month. If there is any excess unadjusted input tax credit for more than 6 months, then the same will be eligible for refund to the taxpayers.

### **2.2.2.1.5 Treatment of Exports and Imports**

For the purpose of exports, no VAT is charged on the transaction and the VAT already paid on the inputs of the goods used for export is deducted - this is an exemption with the right to deduct the input VAT, sometimes called 'zero-rating'. There is thus no residual VAT contained in the export price. However, as far as imports are concerned, VAT must be paid at the moment the goods are imported. Taxable people registered for VAT will be allowed to deduct this VAT in their next VAT return.

#### **2.2.2.1.6 Tax invoice and other records are fundamental to obtain credit**

This entire design of VAT with input tax credit is crucially based on documentation of tax invoice, cash memo or bill. Every registered dealer, having turnover of sales above an amount specified, shall issue to the purchaser serially numbered tax invoice with the prescribed particulars. This tax invoice will be signed and dated by the dealer or his regular employee, showing the required particulars. The dealer shall keep a counterfoil or duplicate of such tax invoice duly signed and dated. Failure to comply with the above will attract penalty.

#### **2.2.2.1.7 VAT Rate**

For the first couples of years, the basic VAT rate was 10 percent, but in mid-January, 2005, the government increased this rate to 13 percent. At present, there is one basic VAT rate of 13 plus a special VAT rate of zero-percent applicable for export.

#### **2.2.2.1.8 Tax Refund**

Under the Nepalese VAT system there is a provision for the refund of VAT. Such a situation will generally arise in the case of zero-rated goods, i.e. exports, where there will be an excess of input tax (the tax on purchases and inputs into the business) over output tax (the tax on sales). The possibility of a tax refund will also arise in the case of domestic sales if the excess of input tax over output tax is reported in each of six consecutive months. Diplomatic persons may request for refund of VAT on basis of their consumption of taxable goods. Likewise, tourist may also claim refund of VAT at the international airport for the goods, which they are carrying abroad.

#### **2.2.2.1.9 Tax Assessment System**

VAT is based on the self-assessment system. Each taxpayer assess his/her tax liability before submitting tax return based on the total input tax paid in purchase and total output tax collected on sales that are recorded in purchase and sale book respectively.

## 2.3 Effectiveness Concept

In general, effectiveness measures intended result. Effectiveness is the extent to which outputs and/or administered items make positive contributions to outcomes. But if we talk about effectiveness of tax audit, a literary meaning can't limit its scope. Different researchers and institutions have identified various effectiveness measurement indicators.

**Canadian Comprehensive Auditing Foundation** has identified twelve attributes to arrive at a consensus on the basic issues of effectiveness of auditing. They are: Management direction, Relevance, Appropriateness, Achievement of intended results, Acceptance, Secondary impacts, Cost and productivity, Responsiveness, Financial results, Working environment, Protection of assets and Monitoring & reporting.

**IRD** has prescribed measurement indicator for effectiveness of tax audit in its **Audit Manual**, they are:

- Total revenue collection
- Tax refund amount
- Appeal amount (disputed) due to tax audit
- Number of audit completed

**New Mexico Taxation & Revenue Department** describes effectiveness measurement criteria to determine whether the basic audit objectives are being met, certain measurement criteria are applied to the audit results. Those measurement criteria can be categorized as follows:

**Quantity-** The quantity of the audits produced is important primarily because a minimum amount of “audit coverage” is necessary to obtain effective enforcement of the tax laws. Audit coverage is the percentage of the total taxpayer population subject to audit in a given year. By tracking the number of audits completed each year the Division can determine whether it is meeting its audit coverage goals.

**Dollars** - The amount of dollars assessed is important because it helps to target the taxpayers who have underpaid or misallocated the largest amount of taxes. By

measuring the dollars generated by audits over a period of time, we can determine whether we are meeting our audit revenue goals.

**Quality** - Generally, quality can be determined from the number and type of review comments generated by supervisors and ATSS, responses to Taxpayer Questionnaires, the number and type of protests received, and the percentage of collection recovery on audit assessments.

**Compliance** – This is the most difficult criterion to apply. It has to do with the affect of the audit effort on the entire taxpayer population. It is presumed that the more audit coverage achieved, the greater the incentive for taxpayers to correctly self-assess. Also, it is presumed that targeting specific industries with reporting issues will assure greater compliance within those industries.

**Banshidhar Ghimire (2006)**, in his report **Study for the measure of tax compliance habit and leakage control** explains the tax compliances are measured using various common and different indicators for different taxes. For example, compliance of VAT is measured by using VAT/GDP ratio, VAT Revenue Ratio, VAT/Tax revenue ratio, gross domestic product plus import VAT ratio, gross domestic consumption /VAT ratio, increase in numbers of tax payers, number of return filers, number of debit and credit returns, number of "zero" returns, number of unsettled returns, cost of collection, numbers of tax payers registered. For income tax, compliance is measured in-terms of tax/GDP ratio, individuals in different income slab and their tax ratio, per capita tax payment.”

Jit B. S. Gill, Lead Public Sector Management Specialist, discusses some of the important indicators for revenue administrations, they are: (The Nuts and Bolts of Revenue Administration Reform)

1. **Total tax revenue/ GDP:** There is a readily available indicator that gives a sense of the fiscal pressure. Comparing the tax to GDP ratio of countries with similar economic and tax structures gives a sense of the relative effectiveness of the revenue administration. Nevertheless, times series data on tax to GDP

ratio, for a given revenue administration, adjusted for changes in tax rates and the tax base, is useful in determining changes in its effectiveness over time.

2. **Actual tax revenue/ tax revenue estimated in the budget:** This indicator shows whether the revenue administration is able to meet the revenue targets set in the budget.
  
3. **Tax revenue gap:** Where reliable data is available, it may be possible to estimate the potential tax revenue that can be collected under the current tax policy and compare it with the tax revenue actually collected. The difference indicates the tax revenue lost due to noncompliance and tax evasion, which is an indication of the overall effectiveness and efficiency of the revenue administration.
  
4. **Amount of tax revenue paid voluntarily/ total tax revenue collected:** Since maximizing voluntary compliance is a major objective of a revenue administration, the proportion of taxes and duties paid voluntarily indicates whether the tax administration is succeeding in this objective, both by facilitating voluntary compliance as well as by creating an effective deterrent against non-compliance through its enforcement activities.
  
5. **Additional tax revenue collected/ the number of declarations audited:** This ratio indicates the degree of success of the revenue administration in detecting concealment of tax liabilities, and therefore, its ability to enforce the tax laws.
  
6. **Amount of tax revenue arrears collected/ Total tax revenue arrears:** This indicator shows the effectiveness of the revenue administration in recovering overdue revenues.
  
7. **Cost of collection:** The ratio of the total annual recurrent budget of the revenue administration to the total revenue collected provides an indication of the efficiency with which the tax administration is deploying its resources to collect taxes.

**8. Client perceptions:** Perceptions of taxpayers, traders, brokers, lawyers and accountants, as reflected in periodic surveys, about the integrity, trustworthiness, fairness, helpfulness and efficiency of revenue administration can provide important pointers to the need for reforms.

## **2.4 Auditing Policy and the Tax Auditing Process in Nepal**

The tax authority of every country is trying to be ensured that the correct tax amount is paid in the correct jurisdiction. The application of self-assessment system provides a broader chance for taxpayers to improve their compliance level voluntarily. This system is supposed to be fairer to both taxpayer and tax administration; however there should be some mechanism to check the compliance level of the taxpayers to ensure the higher compliance level. Tax audit is a critical and significant component for maintaining higher compliance level under this system. It plays an important role to guarantee securing the tax revenue and improving compliance of the taxpayers.

Commonly, tax audit in Nepal refers the full audit where detail audit of income tax, VAT, Excise and withholding tax is done at the same time by the same audit team either in the office desk or in the premises of the taxpayers; however there are also the practices of conducting verification audit, partial audit, link audit, refund audit, withholding audit and investigative audit.

### **2.4.1 Organization of Tax Audit Operations**

Revenue bodies with effective tax audit programs pay close attention to the way this function is organized, resourced, and managed. There is no one “right model” for the organization of tax audit activities. However, IRD has adopted the organizational structures of the ‘functional’ model for organizing tax administration operations and functions are categorized as operation (Taxpayer service), collection and audit & investigation.

Under the functional model, staffs are organized principally by functional groupings (e.g. registration, accounting, information processing, audit, collection, appeals) and generally work across taxes. This approach to organizing tax work

was introduced to enable greater standardization of work processes across taxes, to simplify computerization and arrangements for taxpayers, and to generally improve operational efficiency.

Compared to the ‘tax type’ organizational model from which many revenue bodies have evolved, this model was perceived to offer many advantages and its adoption has facilitated many developments aimed at improving tax administration performance (e.g. providing single points of access for tax inquiries, unified system of taxpayer registration, common tax payment and accounting approaches, and more effective management of tax audit and debt collection functions.) Adoption of the functional model has seen many revenue bodies integrate the management of direct and indirect tax, especially VAT, audit work, leading to some audit officials being responsible for a range of tax types when examining taxpayers’ affairs, rather than confining their inquiries to a single tax type.

#### **2.4.2 Legal Guidelines in Tax Auditing**

The efficiency and effectiveness of a revenue body’s audit activities depends critically on the nature and scope of powers in the underlying legal framework in place, including the provision of adequate powers for obtaining information and an appropriate regime of sanctions to deter and penalize non-compliance.

The efficient and effective conduct of audit activities requires that a revenue body’s audit and investigation staff have appropriate powers of access to information held by the taxpayer and other parties so that taxpayers liabilities reported in their returns can be properly verified or, in the absence of returns, be accurately established. There should also be an appropriate regime of sanctions to punish and deter non-compliance.

For these reasons, revenue bodies require a set of powers and sanctions in the legal framework supporting the conduct of tax administration activities that includes the provision of adequate powers for obtaining information and an appropriate regime of sanctions covering the various offences that may arise. In practice, this legal framework may be set out separately in the laws governing each tax administered

or, preferably for ease of legislative maintenance, in a single comprehensive law on tax administration that provides a common set of provisions covering all taxes. Every country has its own, specific laws and regulations regarding tax auditing. This is no different in the case of Nepal. Nepal's guidelines and rules for carrying out tax audits aim at striking a balance between the competences ('powers') of the tax administration and the protection of taxpayers' and third parties' privacy. On the one hand regulations have been issued that would allow tax authorities to obtain access to documents that are relevant to the levying of taxes. Most of these regulations are included in the Income Tax Act and the Value Added Tax Act.

### **2.4.3 Auditing Competences in General**

Officers of the IRD are authorized to carry out tax audits. The competences regarding tax audits are provided and regulated by the Income Tax and Value Added Tax Act. In general, though, the competences for tax audits under both laws are similar.

Broadly stated, during a tax audit tax auditors have full access to the accounting and the premises of the taxpayer being audited. Tax audits are usually carried out at the premises of the taxpayer. A tax auditor is authorized to obtain access to the private property of taxpayers during carrying out duty.

All companies are obliged to provide the IRD each year with information on taxpayers, such as information on salaries, expenditure allowances, pay in kind, bank balances, interest, closing stock, and retirement fund .

Under the Act taxpayers are obliged to keep reliable and safe books and accounts, which they must retain for a period of six years.

Section 16 of the VAT Act and clause 81 of the Income Tax Act requires a registered person to keep certain books and records. They records must be update and made available at all times for inspection on request of a tax officer.

Section 23 of the VAT Act and clause 82 of the Income Tax Act authorizes a tax officer to examine the books and records at the premises of any person who is registered or who has to be registered. A tax officer may also require some person, including employees of banks or financial institutions to provide access to any information about a taxpayer's business.

#### **2.4.4 Taxpayers' Record-keeping Obligations**

A taxpayer shall keep an up to date account of his/her transaction of the tax period applicable for him/her and such accounts wherever placed shall be made available for inspection to a tax officer upon his/her request( Section 16-1 of VAT act). The accounts kept by a taxpayer should also include

- a) Date of transaction
- b) Value of each transaction
- c) The registration number of buyer, in case it is a registered person and
- d) Other matters as prescribed

A registered person has to maintain duly attested purchase and sales books, and tax accounts. All the documents and records maintained under this act should retain for six years.

#### **2.4.5 Obligation to Provide Information & Access to Information**

The pivotal section regulating the competences of the Nepalese tax administration, as well as the obligation to provide information regarding the taxpayer's income tax is Section 83 of the Income Tax Act, 2058. This Section states that a tax officer may serve a notice in writing on a person, whether he/she is a taxpayer or not,

- a. To produce or prepare and produce any document and any information as required in the notice, within the time specified in the notice.
- b. To attend IRD or IRO at he specified time or place for the purpose of interrogation by the tax officer in a matter concerning taxation of the person or persons.
- c. To produce the documents, which are in possession of the person, as mentioned in the notice at the time of the appearing before tax officer for interrogation

#### **2.4.6 Rights of Inspection & Examination (Section 23 of VAT Act)**

A tax officer may utilize the following powers for inspection, for verification of tax returns and for assessment of tax under section 20 of VAT Act.

- a) To inspect all goods, premises, documents, records, books and accounts relating to tax liability.
- b) To search a taxpayer's place of transaction and other places if he/she has grounds for suspecting to possess evidence related to any offence under this act.
- c) To require, in pursuance with discharging his/her own duties, information from a person who prepares any records, books, accounts or other documents or makes entry therein.
- d) To take possession of, remove and transfer any documents, books and records from the taxpayers' transaction place and other transaction places related thereto,
- e) To perform audits at the taxpayers' place of transaction, at a tax office or at any other appropriate places.

#### **2.4.7 Right of Search & Seizure**

Tax officer after obtaining written approval from the DG of IRD, can use the following rights of search and seizure.

- a) Right of full and uninterrupted access to any premises, place, documents or any other asset, subject to provisions of prevailing regulations.
- b) Right to have a copy of, including an electronic copy of any document to which access is obtained
- c) Right to seize any document that the tax officer decides whether specific information is relevant to the levying of taxes.
- d) Right to seize any asset in order to have an access to a document because the tax officer thinks that the owner has not availed the necessary document.

The tax officer can retain the seized document as long as it is required to determine tax liability or for any judicial proceeding under this act. In case of seizure of an

asset, the tax officer can retain the seized asset as long as it is necessary to obtain an access to and ability to seize the documents under dispute.

This section is used in the case of investigation and the taxpayer who doesn't comply with the tax administration during the course of tax audit. If a taxpayer refuses to co-operate in a tax audit, the police should assist, if requested by the tax auditor. (Section 141 of ITA & section 23ka of VAT Act)

#### **2.4.8 Giving Tax Official Access to Third Party Information Sources**

Section 83 of ITA, 2058 states that a tax officer may serve a notice in writing on a person, whether he/she is a taxpayer or not, to produce or prepare and produce any document and any information as required in the notice, within the time specified in the notice.

If a tax officer requests some person, banks or financial institutions to provide any information about a taxpayer's business, it shall be the duty of such person to provide such information to the tax officer. (Section 23(3) of VAT Act)

#### **2.4.9 Management Assessment in VAT Act**

Section 20(1) of the VAT act provides that a tax officer may make an assessment for taxes, issuing a Tax assessment order (**Annex- IV**) in the following cases:

- If a return is not submitted within the prescribed time limit.
- If an incomplete or erroneous tax return is filed.
- If a fraudulent tax return is filed.
- If the tax officer has reason to believe that the taxpayer has caused under-invoicing and
- In case of supply with under invoicing to group companies.

The tax officer may make such tax assessment on one or more of the following bases. (Section 20(2) of VAT Act)

- a. proof of transactions

- b. a tax audit report on transactions submitted by the concerned tax officer and
- c. tax paid on similar transactions by another person.

Section 20(4) states that any assessment must be made within four years from the time when the tax return was filed. If the stipulated time expires the return so filed shall be considered to be true and valid. In case the taxpayer has prepared accounts, invoice or any other document fraudulently or if he/she has fraudulently been involved in tax evasion, IRD can order an assessment at any time, irrespective of the above time limit.

### **Jeopardy Assessment**

Whenever there is a reason to believe that the collection of tax is in jeopardy because any person is about to leave Nepal or to transfer his/her property to anybody or to remove or conceals assets, a tax officer, with the approval of DG, may immediately assess and collect the tax due, or about to become due.

### **The Burden of Proof**

The burden of proof lies on tax officer for the reasons of the assessment.

### **2.4.10 Amended Assessment in Income Tax Act, 2058**

Sections 92, 100, 101 and 102 in The Income Tax Act provide that a tax officer may make an assessment for taxes, in the following cases:

If the tax officer has reason to believe that the amount of tax was understated or otherwise incorrect

### **Jeopardy Assessment**

Section 100 (2) states that a jeopardy assessment shall be according to the department's best judgments, based on

- ) The person's assessable income for the year from employments business and investment and the source of that income.
- ) The person's taxable income for the year and the tax payable to that income.
- ) In the case of a foreign permanent establishment of a non-resident person situated in Nepal, the foreign permanent establishments repatriated income for the year and the tax payable to that income.
- ) The amount of tax still to be paid for the year after deduction of the tax already paid by withholding, installment or assessment.

Section 102 (2) states that the department may reamed as many times as it thinks is appropriate for tax assessment on justified grounds.

Section 102 states that when the department makes a jeopardy assessment or an amended assessment, the department is required to give a written notice of the assessment to the person stating the following:

A tax payable and the tax to be paid by the person and the assessment for the income year or the period to which the assessment relates.

- ) The manner in which the assessment referred to is calculated.
- ) The reason why the department had to make the assessment.
- ) The date on which the tax still to be paid on the assessment is payable, and
- ) The time, place and manner of objection to the assessment if dissatisfied.

Section 101 (3) states that any amended assessment must be made within four years from the time when the tax return was filed or was due.

Income tax act, 2058 requires a taxpayer to keep certain records and has given authority to tax officials to examine books and records of a registered taxpayer (Section 81, 83). Tax officer may assess additional taxes in different cases. (Section 100,101)

Likewise VAT act 2052 also requires a taxpayer to keep certain records of accounts and provides sufficient ground for tax audit and additional tax assessment (Section 16, 20, 22, 23).

Custom act, 2064 describes about post clearance audit and Excise act, 2058 tells about excise verification. Procedure and audit manual of IRD, 2062 also describes the process and techniques of tax audit. These entire instruments are for the purpose of tax audit.

## **2.5 Types of Audit**

An audit is generally conducted as a periodic control of the taxpayers purchase and sales books, vat account, stock book, submitted vat returns, income tax returns, business accounts and final accounts, if maintained. It is carried out in different ways as follows.

### **2.5.1 Full Audit**

The scope of a full audit is all-encompassing. It typically entails a comprehensive examination of all information relevant to the calculation of a taxpayer's tax liability for a given period. The objective is to determine the correct tax liability for a tax return as a whole. Full audit covers VAT, Income tax and excise also if applicable. All the taxpayer's taxable are verified under the full audit based on risk analysis. Given their broad scope, full audits are typically costly to undertake. A substantial program of full audits will require considerable resources and reduce the rate coverage of taxpayers that could otherwise be achieved by a more varied mix of audit types.

### **2.5.2 Partial Audit**

Partial audits are confined to specific issues on the tax return and/or a particular tax scheme arrangement employed by the taxpayer. The objective is to examine key potential risk areas of noncompliance. These audits consume relatively fewer resources than full audits and allow for an increased coverage of the taxpayer population.

Sometimes, it may be necessary to audit only a part of business transaction in relation to VAT and income tax of a particular taxpayer. For example, there is a possibility of misuse of credit facilities in the case of mixed transaction. So tax auditors may only audit documents relating to credit in order to minimize the risk of the loss of revenue from the misrepresentation of the credit. For income tax partial audits can also be used for verification of procurement of larger investments, e.g. vehicles and construction of building.

### **2.5.3 Verification Visit**

This type of audit is mostly used when a taxpayer requests for VAT refund because of credit carried forward for a continuous period of six months or in the case of exports. It is also used as guiding visits to newly registered taxpayers and de-registration of taxpayers.

### **2.5.4 Link Audit**

Link audit is a type of audit, which is mainly used to examine internal transactions between the businesses that have group interest in other businesses. The main purpose of link audit is to examine the correctness of valuations in connection with internal transactions. This type of audit can also be used for crosschecking transactions between taxpayer.

### **2.5.5 Joint Audit**

Joint audit is an audit of auditing all types of taxes. This type of audit will normally include pay roll audit, full audit, and partial audit. As a rule this type of audit is most extensive and hence, the most time consuming one.

### **2.5.6 Pay Roll Audit**

This type of audit is carried out by an auditing employer who is supposed to withhold income tax from his employees and the purpose of this audit is to ensure that the employer withholds income tax from all paid salaries and taxable benefits to the employees. This type of audit will focus only on the employer's withholding taxes.

### **2.5.7 Investigation**

Investigation is carried out in the case of fraud. In such case, penalties will always be imposed. Although it is a time - consuming type of audit, it should always be considered whether this type or another type of audit is appropriate in the situation or not.

### **2.5.8 VAT-Refund Visit**

A VAT -refund visit is mostly carried out as a verification visit. The visit usually takes place when a taxpayer requests for a value added tax refund because of credit carried forward for a continuous period of six months or in the case of exports. One can find a visit form containing useful acts of control.

### **2.5.9 De-registration Audit**

When a taxpayer requests for VAT deregistration, office performs this type of audit. This audit may be full audit or partial audit or verification audit as per the requirement of the office. Forms for de-registration visits on value added tax has been developed. The forms contains acts of control which would be helpful in the process of de-registration.

## **2.6 Selecting Taxpayers to be Audited**

Audits are a critical and significant component of the compliance activities of revenue bodies in all countries. Faced with limited resources and relatively large numbers of taxpayers to administer, revenue bodies require a systematic risk-based approach for identifying which taxpayers to audit and effective examination techniques to ensure that each audit arrives at a reasonably accurate assessment of each taxpayer's correct tax liability.

Before merging VAT and Income Tax Administrations in 2001, the later one was used to be administered in a traditional ways where all tax returns were needed to be verified and approved by the tax officer whereas VAT returns were used to be filed on the self-assessment system and some selected taxpayers who were supposed to be risky from revenue point of view were audited/investigated by the VAT officials. There were some risk indicators like increasing credit, large credit,

negative value added ratio and refund to find out the risky taxpayers. These indicators were analyzed and selected by the computerized system based on the past record of the taxpayers and the tax officers used to audit those taxpayers who had got higher risk score. When income tax and VAT administrations were merged in 2001, VAT returns and Income Tax returns both were started to be audited at the same time by the same audit team which is also the current practice in the Nepalese tax administration. So, the criteria used in audit case selection of VAT returns were automatically shifted in audit case selection of income tax returns. Income Tax Act 2002 replaced the then needed provision of verifying all income tax returns by the tax officials. Thus, only limited taxpayers are now audited every year. To select those taxpayers, there are some risk-weighting criteria that are analyzed by the computer system based on the data from taxpayer's tax returns. To fix such criteria, there is a formal team in the Inland Revenue Department named Audit Core Group.

Following are the indicators that should be used as risk indicator for selection of taxpayers for the purpose of tax audit. (RD audit manual)

- ) Reliability: records, honesty, business security.
- ) Compliance: Prompt payment,
- ) Credibility: comparison with others in the same trade category.
- ) Accounting complexity: Computer accounts,
- ) Likelihood of fraud: previous case, repeated underpayments,
- ) Revenue risks: tax levels, trade honesty, size of organization,
- ) Status of business: sole proprietor, husband and wife partnership

### **2.6.1 Audit Core Group**

This is, in principle, supposed to be an expert group of some around 10 members, composed of senior tax auditors and a legal official, headed by the director of the investigation (now policy) section in the IRD. The meeting of the group is conducted on the ad hoc basis when there is any need to solve some tax audit issues. This team can fix the audit case selection criteria based on the feedbacks from field Offices, other tax experts as well as on its best judgment and those

criteria will be finally approved by the director general of the IRD before implementing in the case selection process.

### **2.6.2 Audit Case Selection Criteria**

In the existing system, 70 percent of the total audit cases are selected by the Investigation Section of the IRD using the automated system and the remaining 30 percent cases are selected by the respective field offices based on their best judgments. Out of 70 percent cases, 50 percent cases are selected on VAT-returns based criteria such as large credit, large turnover, mixed transaction, increasing credit, decreasing debit, negative VAR, VAT refund and increasing debit. Remaining 20 percent taxpayers are selected based on the IT-returns based criteria such as NP ratio, GP ratio and inventory turnover ratio.

### **2.6.3 Data Used in Audit Case Selection**

Most of the audit case selections are based on the VAT database because of the well record system in VAT comparing to that of income tax. VAT data was computerized fully from the very beginning of its introduction where as income tax data is still on paper documents despite the recent effort to keep it in computer system; and so collecting data from income tax returns and analyzing them is difficult.

Data used in the selection process are as followings:

- ) Data from VAT Returns (turnover, credit tax, debit tax, refund, value-added ratio)
- ) Data from Income Tax Returns (turnover, net profit, gross profit and inventory)
- ) Other reliable information

In this analysis, each taxpayer is analyzed based on the past 2 years' data base record.

### **2.6.4 Data Analyzing System**

There is already computerized data base system in VAT, but not in case of income tax. So, while selecting audit cases based on the VAT data, all taxpayers are equally treated for analysis purpose. Computer program automatically gives the

risk score for all registered taxpayers based on the input conditions decided by the Audit Core Group. So, taxpayers with higher risk score can be easily detected. However because of poor data base system of income tax, the required data for analysis purpose like turnover, gross profit, net profit etera of every income tax return from previous two years, in principle, should be typed in the computer program. After giving such input data and the risk measuring criteria, each taxpayers will be assigned some risk score and so, those taxpayers with higher risk score will be selected for audit purpose. In this process, taxpayers are analyzed and selected based on the official jurisdiction. In other words, taxpayers within each field office (Inland Revenue Office) are analyzed and selected separately from those taxpayers under the jurisdiction of another field office. So, though the criteria are same for all taxpayers, the risk score of a selected taxpayer within one office's jurisdiction may differ from that of another office. So, some times, it may not be fair if we think in national level jurisdiction. However, this system is being followed because of the separate fixed audit target number assigned for every field office. After analyzing the tax returns with so called risk criteria, taxpayers with higher risk score are selected from the computer-processed list by the investigation section of the Inland Revenue Department and then approved by the Director General of the department. Finally, the list of the selected taxpayers will be sent to the corresponding field offices for the audit purpose, normally in three stages.

### **2.6.5 Number of Audit Case Selection**

There are a number of audit types; so number of audit case selection is generally based on number of taxpayer, human resource, number of filed return and return type. (D<sup>1</sup>, D<sup>2</sup> & D<sup>3</sup>)

### **2.6.6 Feedback**

The field offices and the tax auditors who directly involved in the audit process can suggest the Audit Core Group to improve the future case selection criteria and finally to improve its efficiency. Those feedbacks should be, in principle, considered while setting selection system for the next year. For example, in FY 2004/05, all taxpayers were selected by the IRD in central level using the automated criteria; however because of the feedbacks from different field offices,

in FY 2005/06, ACG made provision to select 70 percent cases by the department using the automated system and the remaining 30 percent cases to be selected by the respective field office based on their best judgment. With such change, the respective tax offices, which are monitoring their taxpayers directly, can use the information received and their skills to select the risky taxpayers to audit. So, there is enough opportunity to improve the quality of audit case selection system gradually.

### **2.6.7 Location of Audit**

Tax audits can be conducted in different locations. Sometimes there is a need to carry out the audit at a taxpayer's business premises; in other situations, the books and records required to complete an audit can be collected by, or sent to, IRO and the audit work performed in the office. In normal circumstances, an audit for both value added tax and income tax is carried out at the business address of the company. Tax audits can be categorized as 'field audits' or 'office or desk audits' on this basis.

## **2.7 Preparation and Planning**

### **2.7.1 Audit - Visit Program**

The Inland Revenue offices prepare their audit visit programs for the year to come on the basis of functional target as provided by IRD. The visit list is to allocate to each them by the chief of the Inland Revenue Office. The audit manager (Chief Tax officer in audit) will allocate an appropriate part of the list to each leader, who will make the necessary arrangements. It is necessary to discuss with the chief of the Inland Revenue Office about various aspects of audit.

### **2.7.2 Appointment for Visit**

For appointments made from the selection list, phone calls as well as a written notice should notify taxpayers in advance so that their records and books of account are available for inspection.

### **2.7.3 Visit - Cancellations**

If any group cancels an appointment then the team leader is to arrange an alternative visit. Cancelled visits are to be recorded in the taxpayer file and he is to be visited as soon as possible after the cancellation.

### **2.7.4 Audit Teams Building**

Tax audit visit are to be made by a minimum of two officers in a team. The team leader is to conduct the more complex visits.

### **2.7.5 Preparation for Visit**

No matter what kind of audit is going to take place it is important to make sure that the preparation is done carefully. Before leaving the office the visit teams are to study the information on the taxpayer's files and make themselves familiar with the type of business, form of accounting and any other points relevant to audit.

### **2.7.6 General Review of Past Report**

A general review is an overview of the business with the objective of assessing the viability and effectiveness of the business and the validity of the taxes paid over a longer period, when compared with the general activities and profitability of the business. In the review not only the details of the book keeping transaction & process are known, but also other activities of business, like production, purchase and sales that represent whether the balance sheet is true and fair or not are concentrated. A general review shall always be a part of a full or joint audit when sufficient information's are available and such review is not conducted in the taxpayer premises. It is a part of the preparation of visit and when there is some reason to consider more carefully the taxpayer's position. It has a great value while verifying a substantial claim for refund of credit.

### **2.7.7 Study the Audited Financial Statement (Trading & P/L Accounts)**

A detailed examination of the annual accounts of a business can give some indication of possible tax evasion and position of the profitability of the business. The significant point is that, a business whose profit margin is low, has greater possibility of revenue risk. The declaring low margin return by the taxpayer might

be profit suppressed on sales; that encourage a business to indulge in evasion to restore its competitive position. So the examination of profit and loss accounts and balance sheets of present and previous years is an important function of tax auditing of full and joint audit.

### **2.7.8 Analysis of the Balance Sheet**

Business ratios are important tools for maintaining standard in tax auditing. The profitability, financial security, viability and value of a business are considered basic ratios that can be obtained from the company's profit and loss accounts and balance sheet. The use of ratios is the comparison of the similar result within and outside the organization; moreover, it is also used to compare data of the same organization for past and present year. Disadvantage of the use of ratios is that it does not prove tax evasion and cannot stand by it self. It does however point the possible large-scale evasion and it is a useful audit tool. Computers can very easily calculate ratios such as these and it is the intention, in due course, to build up computerized ratio analysis tools, which will give the officer some useful information.

### **2.7.9 Analysis of Business Ratio**

Gross Profit Margin, Stock Turnover, Current, Quick, Creditor and Debtor ratios are the common ratios, which are analyzed while conducting the tax audit in Nepal.

### **2.7.10 Other Related Information**

The business information of taxpayers can be found from; audit trail report; tax payer profile; VAT and Income tax Returns details; transaction verification from; taxpayers financial statements, business accounts from banks and creditors; information from other external sources; customs and other public institutions and Newspaper & articles.

### **2.7.11 Necessary Items for Auditing Works**

Before leaving an audit visit the important items like; The taxpayer's file and papers; identity card; a copy of audit manual; a notebook; a pocket calculator; a

stock of computer print out; a stock of checklists; a stock assessment forms; cross checking forms; an audit report; relevant acts and rules.

## **2.8 Implementing the Audit - Plan**

It is the important for the implemented audit plan to reflect reflects the overall function of the so and organization. The following steps help to make the audit function more effecting.

### **2.8.1 Initial Action**

On arrival at the taxpayer's premises, the officers should introduce themselves to the taxpayer.

### **2.8.2 Officer's Behavior**

An effective audit entirely depends on the conduct and attitude of the officers. Officers' should not immediately decide about the honesty of the taxpayer. They should not attempt forcefully to get the answers from taxpayers and try to obtain necessary answers.

### **2.8.3 Examining the Business premises**

The audit team should inspect the business premises to obtain a general idea of the business and to assure that all the activities are functioning as per the rules and regulation.

### **2.8.4 Types of Audit Checking**

For convenience the checks carried out in an audit visit can be divided into two types. The basic checking is to be carried out on selective basis. This part sets out these two checks in detail.

#### **2.8.4.1 Basic Checking**

This check is to be completed on all visits and forms the backbone of the audit. The findings obtained from the basic checks will determine the next course of action for the audit. The activities include: registration; past visit records; audit

trail; exports; cash sales; production; external tax report; mixed transaction; profit & loss account; balance sheet.

#### **2.8.4.2 In-depth Checking**

On completion of the basic checks the audit team should have knowledge of the operation of the business and in particular the accounting procedures followed by the business. The team should also have identified some risk areas, which, if investigated in greater depth, may identify revenue loss. When planning in-depth checks, risk and materiality must be taken into consideration. In-depth check may include examination of exports; exempt sales; purchase invoices; credits & debits notes; cash sales: abbreviated invoice; Low value sales; sales invoices; cost of goods sold; carrier's records; import entry documents; goods on consignment; sales return; goods delivery records; gifts; privately used goods; exempt purchase goods & advance payments in the Income tax; taxable income; deduction of interests; deduction of the cost of trading stock; limited deductions and depreciation.

#### **2.8.5 General Review**

A general review is an overview of the business with the objective of assessing the viability and effectiveness of the business and the validity of the income tax and value added tax paid over a longer period, when compared with the general activities and profitability of the business. In the review the officer will not look at the details of the book keeping process, but will concentrate on ensuring that the activities of the business, such as production, purchases and sales, are all represented in the business accounts and give a balanced picture which accords with the declarations made and income tax and value added tax paid by the business over the period. A general review should be conducted by full and/ or joint audits when sufficient information is available. It will also be of value, for instance, in verifying a substantial claim for refund of value added tax credit.

In completion of the audit the officers should: -

- ) Confirm that sufficient notes covering all the action taken during the visit are recorded. In particular, ensure that the notes include all the detail necessary to complete the Audit Report.

- J Summarize all the irregularities found. If it is not possible at this stage to arrive at a precise figure for assessment or additional assessment, make sure that there is sufficient information to complete the calculations at the office.
- J Interview the owner or responsible person of the business and inform him/her about findings. All irregularities and any amounts of tax due at that time should be informed to him/her and if an assessment or additional assessment has not yet been prepared should also be told, he/she is to be informed that it will be delivered to him/her in due course. If possible obtain the taxpayers acceptance of any irregularities.
- J Ask the taxpayer if he has any questions regarding income tax or value added tax. If an answer can be given it should be done. If an answer cannot be given, inform the taxpayer that you will provide the answer and inform him accordingly. Record in your notes any replies given to the taxpayer. Always bring value added tax and income tax brochures for handing out to the taxpayer. It should always be considered to complete an audit as soon as justifiable.

## **2.9 Completing and Reporting**

### **2.9.1 Contents in Audit Report**

On completion of a visit, the officers must submit an audit report which contains basic information; general information and audit information.

### **2.9.2 Writing Audit Report**

It is a necessity to make proper arrangement before writing an audit report. The information deriving on the course of auditing must be analyzed, assessed and compared, and should result in a prioritized list of risk areas for main audit areas based on materiality and risk. Furthermore the list must be divided stating audit steps concerning sales, purchases, expenditures, stock valuation and other areas from the balance sheet.

### **2.9.3 Audit-Result**

The audit must be result-oriented so as to meet the objectives of conducting audit. The reports must be based on the principle of canon of taxation and the principle of accretion. The tax report must follow the Arm's Length Principle. The report must be fair, accurate, unbiased and logical and consistent with legal provision. The report also includes the information and discussion in any specific topics; large investment items; thing to be follow-up in next visit. Reports are to be filled in the taxpayer's folder and retained for a minimum of six years.

### **2.9.4 Execution and Forming a Judgment (Findings)**

Provided that fraud is not suspected, any errors leading to underpayment of value added tax and/or income tax should be analyzed and the amount established. The taxpayer should then be informed and, if possible, his acceptance of the calculations and the amount of tax due obtained. If the underpayment cannot be calculated or the taxpayer does not agree the tax due, he/she is to be advised that the necessary records will be retained. They should then be taken to the office and the underpayment should recalculate and reconfirmed. A receipt is to be given for any books or records removed from the premises and they should be returned at the earliest possible opportunity. The date of removal and the date of return of the books or records are to be recorded on the visit report.

### **2.9.5 VAT Visit Report (VVR) Entry**

On completion of any visit the officer is to complete a computer advice slip VAT Visit report. This report updates and extends the information held on the computer. The advice slips are to be attached to the report. The taxpayer folder, report and advice slip is then to be passed to the team leader.

### **2.10 Management Assessment & Amended Assessment**

In the course of visit, if an officer discovers irregularities, which proves that the taxpayer has paid lesser amount of income tax and/or value added tax than is due, or has incurred penalties or interest charges; an assessment order is issued.

## 2.11 Computer Assessment

Especially in value added tax, there is the provision to assess by computer-program known as computer assessment. When a taxpayer fails to submit the tax return then the computer itself makes an assessment on the basis of the transaction of the previous periods. Such assessment is being dispatched to the taxpayer's address offer being signed by tax official. If the taxpayer files the self-assessed return, the system itself replaces the previous computer assessment

## 2.12 Common Errors

The following common errors were found during the courses of auditing. They are:

- ) PAN not found in tax invoice
- ) Purchase/sales/VAT account/invoices not in prescribed format.
- ) Invoice date instead of customs declaration date.
- ) Improper filing of VAT related documents/Scattered in many places.
- ) No tax invoice printed in the first copy of the invoices.
- ) Tax invoice printed in all copies of the invoice.
- ) Misuse of debit note and credit note.
- ) Claim of Zero rate in the sales in foreign currency
- ) Posting of many invoices in a lot.
- ) Return filling and total of debit/credit
- ) Excess credit in return than in purchase account.
- ) Lack of original purchase bill.
- ) Export document (e/c, customs declaration form, bank draft )
- ) No serial number on invoice/hand-written serial number
- ) Full credit claim of partial creditable goods. (e.g. Vehicles)
- ) Credit claims the telephone bill of other individual instead of the taxpayer.
- ) Posting of export in exempted column instead of Zero-rated.
- ) Direct posing in tax return without account keeping
- ) Claim of the credit of entertainment bill
- ) Credit claim of the Customs deposit amount.

- J All purchase invoice of which input tax has been claimed are not related to actual tax period (related to future/past tax periods)
- J Sales invoice from actual tax period accounted for future tax periods.

### **2.13 International Aspects of Tax Auditing**

As per Double Taxation Treaty Agreement, the competent authorities of the States under double taxation treaty shall exchange information as is necessary for carrying out the provisions the Agreement or of the domestic laws of the Contracting State concerning taxes covered by the Agreement, insofar as the taxation there under is not contrary to the Agreement, in particular for the prevention of evasion of such taxes. Nepal has done Double Taxation Treaty Agreement with 10 countries. So, it can also be used for audit& investigation purposes.

### **2.14 Other Related Researches**

OECD has done a comprehensive analysis on tax audit of its member countries and shed light on different aspects. Some related topics for our research are stated hereunder: (Strengthening Tax Audit Capabilities: General Principles and Approaches)

**Tax audit:** A tax audit is an examination of whether a taxpayer has correctly assessed and reported their tax liability and fulfilled other obligations. Tax audits are often more detailed and extensive than other types of examination, such as general desk checks, compliance visits/ reviews or document matching programmes.

**Types of audits:** Audits can vary in their scope and the level of intensity to which they are conducted. For this reason, various terminologies have evolved to describe different types of audit activity:

- Full audits
- Limited scope
- Single issue

In practice, the scope and nature of any audit activity undertaken for a particular taxpayer will depend on the available evidence pointing to the likely risks of noncompliance and a taxpayer's prior history. Extensive audit inquiries may also be justified simply because a taxpayer's financial and /or business activities are unusually complex.

**Periods under examination:** Audits can focus on one financial year or accounting period, or be extended to cover multiple fiscal periods.

**Location of audits:** Tax audits can be categorized as 'field audits' or 'office or desk audits' on the basis of location.

### **Legal framework**

The efficiency and effectiveness of a revenue body's audit activities depends critically on the nature and scope of powers in the underlying legal framework in place, including the provision of adequate powers for obtaining information and an appropriate regime of sanctions to deter and penalize non-compliance.

Following are the key elements of such a legal framework as it relates to the audit function. These are:

- Taxpayers' record-keeping obligations
- Giving tax official's access to taxpayers' books and records.
- Giving tax officials' access to third party information sources.
- Obtaining information from other countries' revenue bodies
- Powers of revenue bodies to amend returns.
- Sanctions for non-compliance.

### **Examination Techniques**

An auditor will apply various techniques to examine the books and records behind a return. These will vary with the customer and the tax regime concerned. Broadly they will adhere to a few key principles:

**Analytical review** - An analytical review of financial statements and returns as filed is often completed during the preliminary stages of the audit.

**Investigative approach** - Auditors are encouraged to use an investigative approach in their audits. Such an approach uses information obtained through observation, discussion, documents or records obtained from either the taxpayer/registrant or from other sources; it requires judgment, imagination and using information outside the accounting records to perform the audit.

**Records Examination** - The main approaches to detect false accounting include the examination of books and documents conducted at the taxpayer's business office or branches, counterpart examinations and examination of savings and deposit accounts. Examples include:

- Cross-checking purchase and sales invoice to look for the possibility of off record sales;
- Cross-checking declared sales with money deposited into bank accounts to identify indications of diverted income;
- Cross-checking appointment or order books with sales invoices to look for the possibility of off-record sales; and
- Checking purchases and sales invoices for any information that might indicate forms of ancillary income.

**Third party information/Counterpart examinations** - Where necessary, information can be obtained during the course of an audit from third parties to verify the taxpayer's income.

#### **Audit workforce management issues**

- Without competent staff, tax audit activities will not achieve their objectives.
- Performance management is an important tool for shaping auditor behaviour.
- Competency models and competency improvement activities help develop and manage the audit workforce
- Both initial and ongoing training is essential for all audit staff.

#### **Measures of audit yield, productivity, and volume**

1. Total assessed tax and penalties: The aggregate value of assessments resulting from all audit activities or by class/type of audit activity.

2. Total revenue collected in respect of assessed tax and penalties: The aggregate value of revenue collected within the fiscal year from that year's audit activities.
3. Average tax and penalty per case (i.e. taxpayer): The total value of assessed tax and penalties divided by the number of completed audits (including nonproductive audits), noting that an audit may cover multiple years and tax.
4. Number of completed audits, both productive and non-productive: The aggregate number of completed audits from all audit activities over a defined period. This number might be broken down into sub-categories (e.g. by class /type of audit, tax type)
5. Average tax and penalty per unit cost: The total value of assessed tax and penalties divided by agreed unit cost measure (e.g., the cost of employing one audit official for a full year.
6. Relative size of understatements detected: The total value of adjustment made as a result of audit as a proportion of total assessed liability
7. No change/ adjustment rate: The proportion of audits where no assessment results from the examination undertaken.

The Audit Strategy of IRD of New Zealand outlines eight key principles that provide clarity to the context and purpose of Audit activity. (The Strategic Principles for Audit, Business Plan—The Way Forward, 2001:168)

1. Audit has a key role in the wider process of compliance management.
2. The outcome of Audit activity is maintaining and improving compliance.
3. Audit staff is highly skilled, motivated, and equipped to achieve quality outcomes.
4. Technology supports and enhances all aspects of Audit.
5. Audit is strongly focused on the identification of compliance risk, based on credible intelligence.
6. Audit activity concentrates on high risk but is still visible throughout the community.
7. Audit applies a range of interventions to maintain and improve compliance.
8. Audit activity supports measures to reduce compliance costs.

The Inland Revenue has initiated an Audit Strategy program to implement these key principles.

**Matthew Rablen & Stephanie Clarke**, in their study, “Enforcing Tax Compliance: Audit Probability versus Audit Effectiveness” found that expected tax revenue is always raised by a simultaneous and resource neutral increase in audit effectiveness and decrease in audit probability. Their model suggests that Government revenue collection departments should place more emphasis on the effectiveness of their audits over how many they perform. A potentially testable prediction of their model is that, to the extent that the decline in audit probabilities is due to the forces outlined in the model, higher levels of audit effectiveness in those remaining audits will have offset the decline in audit probability.

However, **James Alm & Michael McKee** in their study Audit Certainty, Audit Productivity, and Taxpayer Compliance suggest that increasing audit productivity alone is not effective. It is only when greater audit productivity is combined with a higher audit probability that the overall effect on compliance is positive.

“Audits are a critical and significant component of the compliance activities of revenue bodies in all OECD countries. Faced with limited resources and relatively large numbers of taxpayers to administer (especially in the SME sector), revenue bodies require a systematic risk-based approach for identifying which taxpayers to audit and effective examination techniques to ensure that each audit arrives at a reasonably accurate assessment of each taxpayer’s correct tax liability.” (Strengthening Tax Audit Capabilities: Innovative Approaches to Improve the Efficiency and Effectiveness of Indirect Income Measurement Methods, 2003:362)

“Good revenue authorities identify and assess compliance risks and develop strategies targeted at addressing those risks. These strategies include education, service, and marketing, profiling risk, auditing, general anti avoidance efforts, prosecution and proposals for legislative change.”(OECD Practice note-Principles of Good Tax Administration, 2001:211)

The Secretary of Prime-minister's secretariat office, former DG of then VAT Department, Narayan Silwal is satisfied with the implementation value added tax, he expressed his view as what achieved in short period even **contracting** situation is satisfactory and emphasized more on functional structure, functional target

setting, establishing effective MIS mechanism, stimulated and quick refund and strong monitoring system. (Four Years of Implementation of Value Added Tax, 2001, IRD)

Lal Bahadur Khatri in his dissertation “Effectiveness of self assessment tax system in Nepal” explains that the audit and investigation function should be directed from full scope examination of the transaction towards limited issue focused examination (LIFE) of the taxpayer’s business. It will help to develop professionalism in tax administration.

Chet Nath Dahal describes in his “Tax Auditing system in Nepal (2007)” that tax auditing is necessary when a gap exists between tax return and books of accounts....it is fact that the audit has great role in the success or failure of tax department”. He has outlined effectiveness of audit programme of IRD considering management assessment and its contribution on tax revenue as a major outcome.

A study by **World Bank (2008)** showed paying taxes indicator of south Asian nations as follows:

**Table 2.1**  
**Paying Taxes Indicator of South Asian**

Countries	Tax payment period	Average tax rate	Tax payment frequency	Relative status
Nepal	408	32.5	33	92
India	271	70.6	60	165
Maldives	0	9.1	1	1
Pakistan	560	40.7	17	146
Bangladesh	400	39.5	-	61
Afghanistan	275	35.5	6	38

Cited from Annual report of IRD

## **CHAPTER – III**

### **RESEARCH METHODOLOGY**

This chapter is concerned with detail discussion of the methodology used in this study by covering the procedure of getting research problems answers as per the objectives. There are four parts as Research Design, Nature and source of data, Data collection procedure and Data processing and Analysis procedures.

#### **3.1 Research Design**

This study is to measure the effectiveness of tax auditing system of IRD. It was qualitative in nature and based on survey as well as secondary data. The data was descriptive and explorative in nature. The analysis was done on basis of available data, views of stakeholders and associated personnel so as to bring in rating scale to evaluate or measure the effectiveness of tax audit. Some quantitative secondary data were also taken so as to analyze the effectiveness of tax auditing in Nepal.

#### **3.2 Source of Data**

The study was qualitative and subjective in nature. The study was basically depending upon secondary data. However, primary data, collected from different field of taxation as stated above, were used to reach in conclusion.

- a. Collection of Information through Primary sources: This was carried out by Questionnaire and opinion Survey of the taxpayers, tax auditors and tax officials.
- b. Collection of Information through Secondary sources: Reports, manuals, brochures, and other reference materials from ministry of finance and IRD were used for this purpose.

Three set of questionnaire were distributed among 75 persons, 25 from each group on the basis of convenient approach. In the group of tax auditor, 20 were sent to

the business auditors and 5 to the revenue auditors of OAG/N. The respondents were from Kathmandu valley only.

The questionnaires were distributed personally and, in case of failure that was delivered my mail. The judgment sampling method was used to distribute among above three blocks by the decision of researcher.

### 3.3 Population and Sample of the Study

All tax officers, business firms (taxpayers) and tax auditors (include both registered business auditors and revenue auditors from OAG/N) are population of the study. Therefore, sample research was carried out in this study. The sample size was taken 75 number of population and it was divided into three different groups, i.e. tax officials, business firms(taxpayers) and tax auditors (include both registered business auditors and revenue auditors from OAG/N) and equal chances of being selected heterogeneously. Three sets of structured and close-ended questionnaire (Annex-I) were prepared with sufficient coverage of audit works to reach to the conclusion.

S.N	Respondents	No. of Questionnaire Distributed	Sample Size	% Received
1	Tax Officers	30	25	83.33
2	Business firms(Taxpayers)	30	25	83.33
3	Tax Auditors	35	25	71.43
Total		95	75	

### 3.4 Method of Analysis

The data were properly organized and presented in appropriate tables, charts and graphs. The percentage and trend analysis were used to analyze the data. The conclusions, recommendations are based on study findings and various reference materials.

### 3.5 Data Processing and Analysis Procedures

For the analysis, all collected data and information of various aspects of income tax was arranged in order and processed. Then, the descriptive tools and statistical tools such as simple percentage, simple average, graphs, charts, diagrams, Table time series analysis, have been applied in the way of analysis so that the findings could be presented and interpreted precisely and properly in order.

## CHAPTER – IV

### PRESENTATION AND ANALYSIS OF DATA

This chapter deals with the present status of tax audit through secondary data. Secondary data derived from the authorized agency's publication were used to examine the present status of tax administration.

#### 4.1. Secondary Data Analysis

##### 4.1.1. Tax Revenue Contribution to Treasury

The table 4.1 shows the contribution of tax revenue to the nation treasury with the respect to fiscal year 2007/08. The total tax revenue of fiscal year 2005/06 to 2007/08 has increased by 31.46 percentages. The non tax revenue has increased only by 3.57 percentages. However, such increase is due to the rate increased in VAT from 10 to 13 percent (in 2061 Magh)

**Table 4.1**  
**Tax Revenue Collection Statement**

( Rs. in million)

<b>Tax Heading</b>	<b>2005/06</b>	<b>2006/07</b>	<b>2007/08</b>
<b>Customs</b>	15701.6	15344.0	16708
<b>Excises</b>	6445.9	6507.6	9343.2
<b>VAT</b>	18885.4	21610.7	26095.6
<b>Income Tax</b>	11272.6	11786	16727
<b>Other</b>	1799.2	2181.1	2253.5
<b>Tax Revenue</b>	54104.7	57428.8	71127.3
<b>Non-tax revenue</b>	16018	14851.6	16590
<b>Total revenue</b>	70122.7	72280.4	87717.3
<b>GDP at producer price</b>	589411.6	654054.5	727089.0

Source: - Economic Survey 2007/008 Government of Nepal, Ministry of finance July, 2008

The table 4.1 shows the amount of the tax revenue has been contributing at the state treasury. The total tax revenue has been growing and VAT and income tax have increased more than usual in 2007/08.

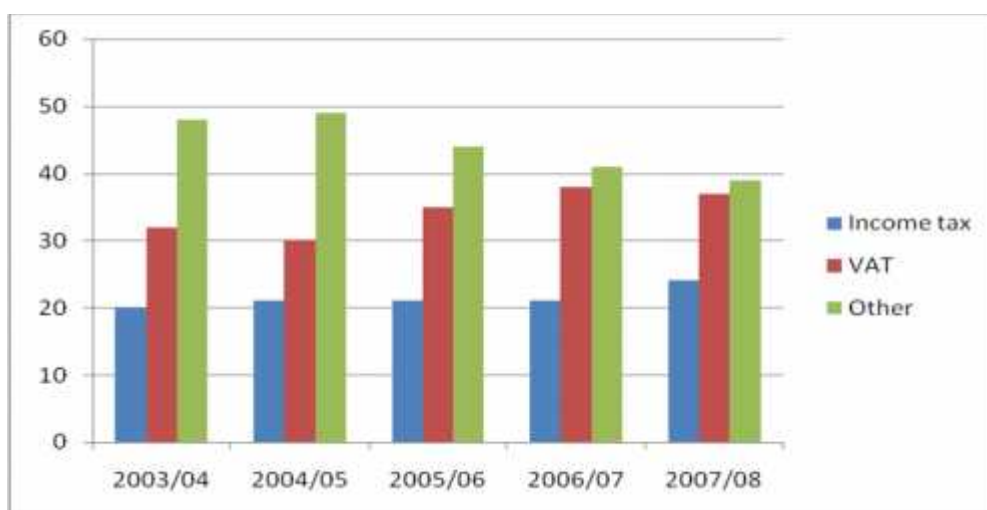
The table 4.2 shows the percentage combination of income tax, VAT and Other to total revenue.

**Table- 4.2**  
**The Combination of Revenue**

Year	2003/04	2004/05	2005/06	2006/07	2007/08
<b>Income tax</b>	20	21	21	21	24
<b>VAT</b>	32	30	35	38	37
<b>Other</b>	48	49	44	41	39
<b>Total</b>	100	100	100	100	100

Source: - Economic Survey 2007/008 Government of Nepal, Ministry of finance July, 2008

**Figure 4.1**  
**Combination of Income Tax, VAT and Other to Total Revenue**



The figure 4.2 shows the contribution of income tax, VAT and other upon the total revenue. Others indicate the customs excise and other direct and indirect taxes that contribute much more in comparison to income taxes VAT.

#### **4.1.2. VAT & Income Tax on Revenue, Tax Revenue & GDP**

The income tax and VAT with respect to the GDP ratio is shown in table 4.3. It is observed that the income tax and VAT ratio to the GDP with respect increased from 4.50 to 5.88 by 1.38 over in five years. Per year increase was only by 3.19 percent. It is least increased to the comparison of least developed countries.

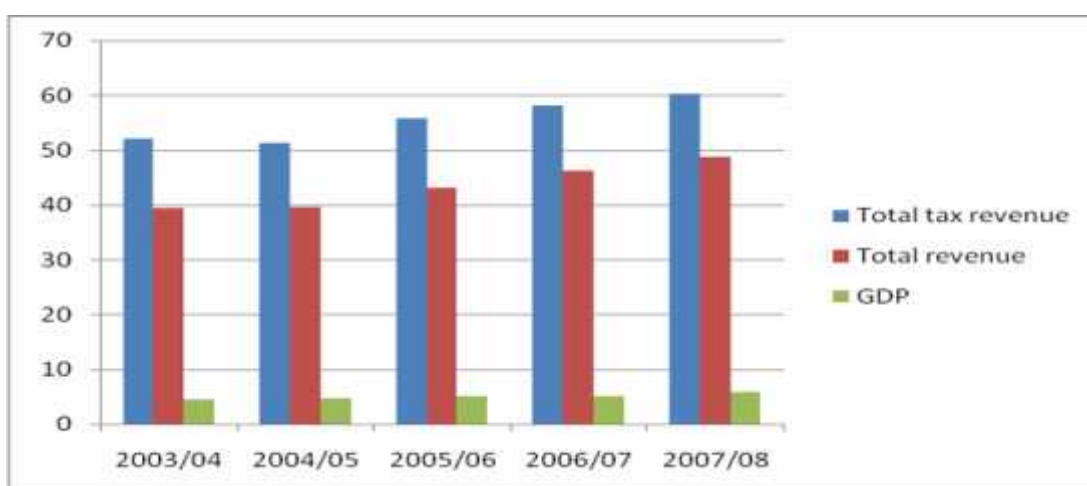
The table 4.2 shows the percentage combination of VAT & Income Tax on Revenue, Tax Revenue and GDP

**Table 4.3**  
**VAT & Income Tax on Revenue, Tax Revenue and GDP**

<b>F/Y</b>	<b>2003/04</b>	<b>2004/05</b>	<b>2005/06</b>	<b>2006/07</b>	<b>2007/08</b>
<b>Total tax revenue</b>	52.01	51.26	55.74	58.15	60.20
<b>Total revenue</b>	39.39	39.61	43.00	46.20	48.81
<b>GDP</b>	4.50	4.60	5.11	5.10	5.88

Source: - Economic Survey 2007/008 Government of Nepal, Ministry of finance July, 2008

**Figure 4.2**  
**Revenue Share on GDP**



#### **4.1.3. Total Revenue, Tax Revenue & Non - tax Revenue on GDP**

The indicator of economic activities, which is shown in table 4.3, indicates that total revenue in year 2003 was 11.42 and increased by 12.06 in 2007 in comparison to GDP. The increase 0.64 percentages have to play great role in the national building. However, the increment lags behind the set targets of the government.

The table 4.4 shows the percentage combination of total revenue, total revenue, non tax revenue and inland revenue.

**Table 4.4**  
**Economic Indicators**

Indicators	2003/04	2004/05	2005/06	2006/07	2007/08
Total revenue	11.42	11.61	11.89	11.05	12.06
Total revenue	8.65	8.97	9.17	8.78	9.78
Non tax revenue	2.77	2.63	2.71	2.27	2.28
Inland revenue	5.73	6.55	7.25	6.75	7.68

Source:- Economic Survey 2007/008 GON, MoF, July, 2008

#### 4.1.4 Revenue Target and Achievement

The table 4.5 shows the revenue target and achievement in the fiscal year 2004/05 to 2007/08.

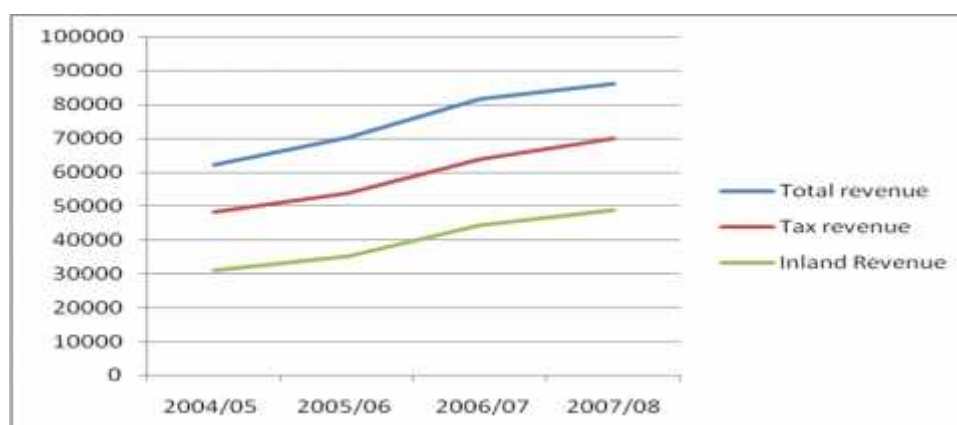
**Table 4.5**  
**Revenue Target and Achievement**

Indicator	Rs. in millions							
	2004/05		2005/06		2006/07		2007/08	
	E	C	E	C	E	C	E	C
Total revenue	62227	62331.1	70320	70027	81816.6	71733.1	86135.5	87711.2
Tax revenue	48155.2	48173.3	53770	54053.4	63850	57430.4	70046.2	71126.7
Inland Revenue	31011.2	30921	35200	36552.8	44300	40202.3	48698.5	51541.4

E= Estimation, C= Collection

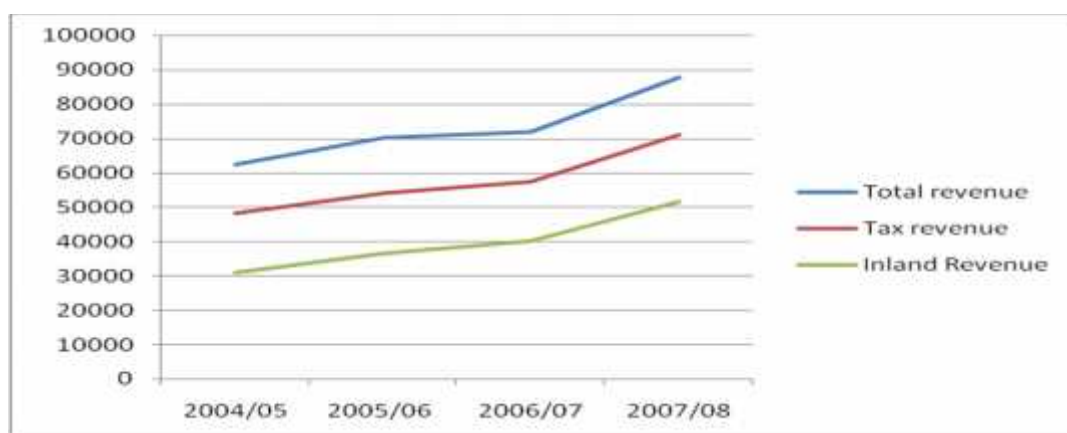
Source: Annual Budget & reports of IRD

**Figure 4.3(A)**  
**Revenue Target**



**Figure 4.3(B)**

**Achievement**



Total revenue, tax revenue and Inland Revenue were collected as per estimation in the year 2007/08, after failed to achieve target in the last two years though IRD succeeded to collect as per estimation in the year 2005/06 and close to the target in the year 2004/05.

#### 4.1.5 Revenue Collection Costs

The following table 4.5 shows the tax collection costs from F/Y 2003/04 to 2007/08. The revenue collection cost is considered as significant indicator for the measurement of the organization's effectiveness. The cost of collection has gone down when excise tax was included and such cost is mainly borne by the enterprise selling the goods. The cost of collection as compared to the European countries is low. When cost of collection is less than 0.5 percentages, it is considered good. It should, however, be remembered that European tax authorities collect value added tax and tax from all businesses including the small business where the cost of collection is higher.

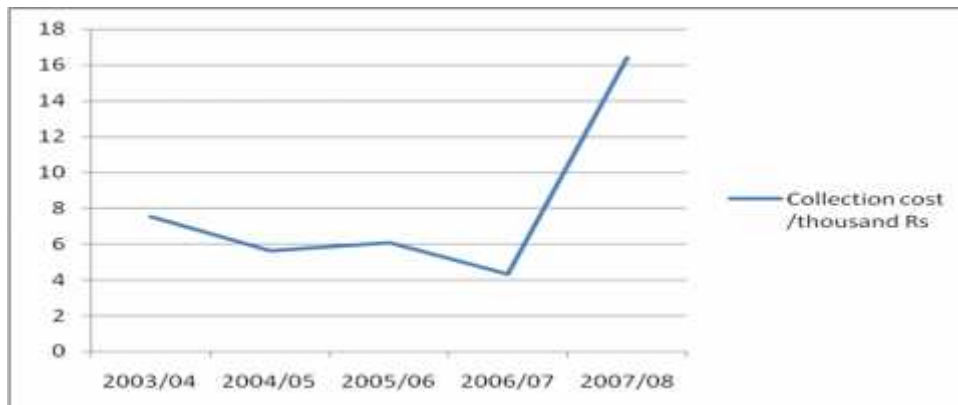
**Table 4.6**  
**Revenue Collection Cost**

(Rs. In million)

Fiscal year	2003/04	2004/05	2005/06	2006/07	2007/08
Operating expenses	137.59	113.1	137	106.48	532.17
Total Collection	18223.9	20060.6	22439.5	24505.4	32488.6
Collection cost /thousand Rs	7.55	5.64	6.11	4.35	16.38

Source: Annual Report of IRD

**Figure 4.4**  
**Revenue Collection Cost**



According to the report of IRD, revenue collection cost per thousand was Rs. 4.35 in 2006/07 but it was highly increased i.e. 16.38 in 2007/08 that is mainly due to increase in capital expenditure.

#### **4.1.6 Tax Assessment Amount**

The table 4.7 shows the MA of income tax target and achievement and MA of VAT target and achievement in the fiscal year 2004/05 to 2007/08

**Table 4.7**  
**Tax Assessment Amount**

(Rs. In million)

Fiscal Year	MA of income tax			MA of VAT		
	Target	Achievement	percentages	Target	Achievement	percentages
2004/05	1864	1566	84	678	617	91
2005/06	2055	1850	90	773	503	65
2006/07	2339	3328	142	705	502	71
2007/08	2594	3790	146	571	499	87

Source: Annual report of IRD

**Figure 4.5**  
**Tax Assessment Amount**

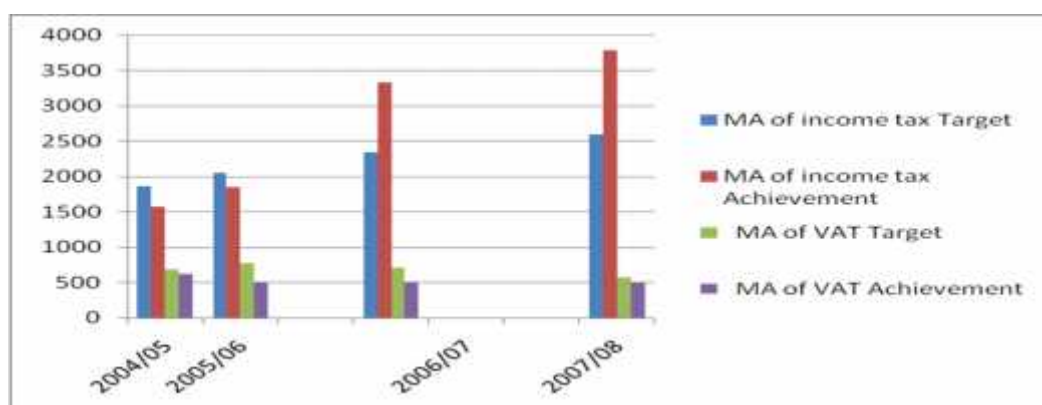


Table 4.7 shows that the management assessment in VAT was not made as per the target even though income tax assessment had increasing trend with the achievement of target. In case of VAT there was up and down in the assessed amount by 91 percent, 65 percent and 87 percent of target in the years 2005/06, 2006/07 and 2007/08 respectively. The fall in assessed tax amounts in the year 2005/06 was due to highly political instability and different movements.

#### **4.1.7 Management Assessment and Appeal**

The table 4.8 shows the management assessment & appeal in the fiscal year 2004/05 to 2007/08

**Table 4.8**  
**Management Assessment & Appeal**

(Amount in 000 Rs.)

Fiscal year	No. Of audit	Amended assessment amount	No. Of appeal (Percentages Of no. Of audit)	Appeal amount (percentages of AA amount)
2004/05	2107	70,78,21	249(11.8)	46,94,85(66.3)
2005/06	1908	1,57,40,00	331(17.3)	1,35,04,23(85.7)
2006/07	2152	1,85,00,00	295(13.7)	84,92,46(45.9)
2007/08	3286	3,32,87,41	239(7.3)	1,22,86,03(36.9)

Source: Annual reports of IRD

Amended assessment amount of Income tax is taken only for comparing appeal status due to unavailability of Appeal amount on VAT. Above statistics reveals that percentage of appeal cases and amount is decreasing.

#### 4.1.8 Tax Audit Achievement

The table 4.9 shows the tax audit achievement in the fiscal year 2005/06 to 2007/08

**Table 4.9**  
**Tax Audit Achievement**

Kinds of audit	2005/06			2006/07			2007/08		
	T	A	P	T	A	P	T	A	P
<b>Full Audit</b>	2995	2107	70 percentages	2785	2152	77percentages	2284	3286	144percentages
<b>Link Audit</b>	42	10	23 percentages	0	0	0percentages	49	33	67percentages
<b>Investigation</b>	40	110	275percentages	138	133	96percentages	300	267	96percentages
<b>Sudden Visit</b>	5000	3773	75 percentages	3100	4482	145percentages	5025	3244	65percentages
<b>Group Audit</b>	0	0	0 percentages	0	0	0percentages	100	21	21percentages
<b>TDS/Payroll Audit</b>	3200	2469	77 percentages	1590	1532	67percentages	325	2281	701percentages
<b>Zero Return Verification</b>	6000	425	7 percentages	1190	1036	87percentages	1318	2198	167percentages
<b>Partial Audit</b>	0	0	0 percentages	545	518	95percentages	525	418	79percentages
<b>G. Vat Verification</b>	0	0	0percentages	1330	1222	92percentages	3049	4089	134percentages
<b>Refund Verification</b>	0	0	0percentages	387	368	955	374	355	95percentages

T=Target, A=Achievement P=Per cent

Source: - Annual report of IRD

The above data indicates that IRD is using different type of auditing system so that tax evasion will be reduced as desired and efficiency on self-assessment is increased. It seems that performance in-group audit is poor whereas TDS audit is performing well and increasing. It's also observed from the above table that most of the functions of VAT were displayed in functional target than income tax functions. IRD organization has been administrating functional line in VAT than income tax even after merging both the existing organization into IRD.

**Table 4.10**

**Selection of Taxpayer for Audit and Investigation**

Fiscal year	Total registration of taxpayer	Selection for audit and investigation	Percentage of selection for audit
2004/05	191156	2802	1.31
2005/06	225304	2923	1.15
2006/07	245550	5217	2.12
2007/08	274253	4755	1.73

Source: Annual report of IRD.

The VAT department had policy regarding taxpayer selection for audit was 10percentages of total taxpayers or one for every four years on rotation basis. Though IRD has made some criteria for selection, there is no any fixed audit policy and every year such criteria keep on changing. In 2007/08, selection of audit on VAT and income tax basis has increased the target where 2.12 percentages of taxpayers were selected for audit and investigation.

**Table 4.11**

**Audit and Investigation Performing During the Years**

Fiscal year	Total registration of taxpayer	Audit and investigation performance	Percentage of selection for audit
2004/05	1,91,156	2091	1.09
2005/06	2,25,304	2285	1.01
2006/07	2,45,550	5328	2.17
2007/08	274253	5331	1.94

Source: - Annual Reports of IRD

Table 4.11 shows that the taxpayers were audited in 2005/06, 2006/07 and 2007/08 year by 0.98, 0.90 and 2.17 respectively against the target of 1.31, 1.15 and 2.12 of the Department. In 2007/08 target was increased and the conduction of tax audits seems to be desired by tax administration. But target setting may be unrealistic or allocation and release of fund may be insufficient.

#### 4.1.9 Human Resources in Audit

Table 4.12 shows that targets for each tax auditing staff were set at around 14 taxpayers per year in 2005/06, 2006/07 and 2007/08, around 38 taxpayers per year were audited form each staff. Here, targets were increased but organizational structure has not been changed yet. The standard size is difficult to find because it involved human factor. It is true that the volume of transaction of taxpayers may not be same and size may be varying. However, the IRD should focus on intensive analysis regarding the method and manner of performing audit practice.

**Table 4.12**

##### Level wise Auditing Staffs

<b>Organization</b>	<b>2<sup>nd</sup> Class</b>	<b>3<sup>rd</sup> Class</b>	<b>N.G</b>	<b>Total</b>
Department	1	10	6	17
L.T. Office	2	14	7	23
Categories A office	3	21	21	45
Categories B office	0	10	10	20
Categories C office	0	30	30	60
Categories D office	0	15	15	30
<b>Total</b>	<b>6</b>	<b>100</b>	<b>89</b>	<b>195</b>

Source: - Annual Report of IRD

The table 4.13 shows the auditing staffs in the fiscal year 2005/06 to 2007/08

**Table 4.13**  
**Auditing Staffs**

<b>Fiscal year</b>	<b>Audit staff</b>	<b>Total staff in department</b>	<b>Audit staffs in total staff percentages</b>
2004/05	195	924	21.1
2005/06	195	924	21.1
2006/07	195	924	21.1
2007/08	195	924	21.1

Source: - Annual Report of IRD

#### 4.1.10 Compliance Measurement through Registration

The table 4.14 shows the compliance measurement through registration in the fiscal year 2003/04 to 2007/08.

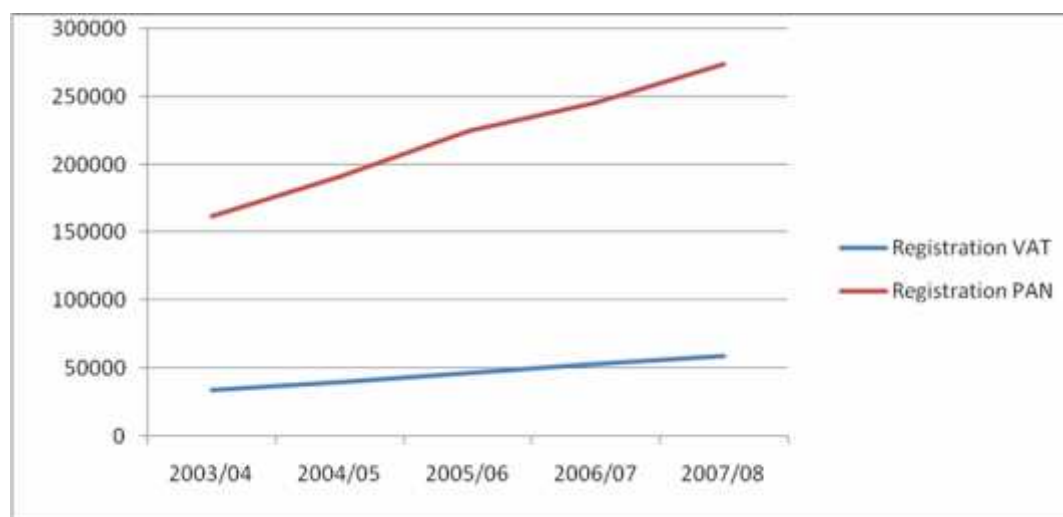
**Table 4.14**  
**Compliance Measurement through Registration**

F/ Y	VAT	Percentages Change	PAN	Percentages Change
2003/04	34174	14	162172	16
2004/05	39776	16	191156	18
2005/06	46831	18	225304	18
2006/07	52965	13	245550	9
2007/08	59047	12	274253	12

Source: Annual reports of IRD

**Figure 4.6**

**Compliance Measurement through Registration**



The table 4.14 and figure 4.6 shows that new taxpayers have been increasing every year but in 2006/07 & 2007/08 growth rate were slightly low in comparison to 2005/06 and 2006/07. Up to 2007/08, 21.53percentages taxpayers have registered in VAT among total PAN holders. Both VAT & PAN registrants are increasing almost same percent except F.Y. 2007/08.

#### 4.1.11 VAT Comparative Statistics and Composition of Returns

The table 4.15 shows the VAT comparative statistic on return in the fiscal year 2004/05 to 2007/08.

**Table 4.15**  
**VAT Comparative Statistic on Return**

Areas	2004/05	2005/06	2006/07	2007/08
Total returns	25049	28525	33633	36457
Debit-returns	8483	9478	10449	11457
<b>percentages in total</b>	33.87	33.2	31.06	31.43
Credit-returns	9625	10260	12882	13594
<b>percentages in total</b>	38.42	36	28.17	37.29
Suspended returns	158	516	163	362
<b>percentages in total</b>	0.63	1.8	0.4	0.99
Nil-returns	6783	8271	10139	11044
<b>percentages in total</b>	27.08	29	30.14	30.29
Non-filer	7322	8492	13198	7098
Non filer percentages	21.43	22.96	21.63	14.58

Source: Annual report, IRD

**Figure 4.7**

**VAT Comparative Statistic on Return**

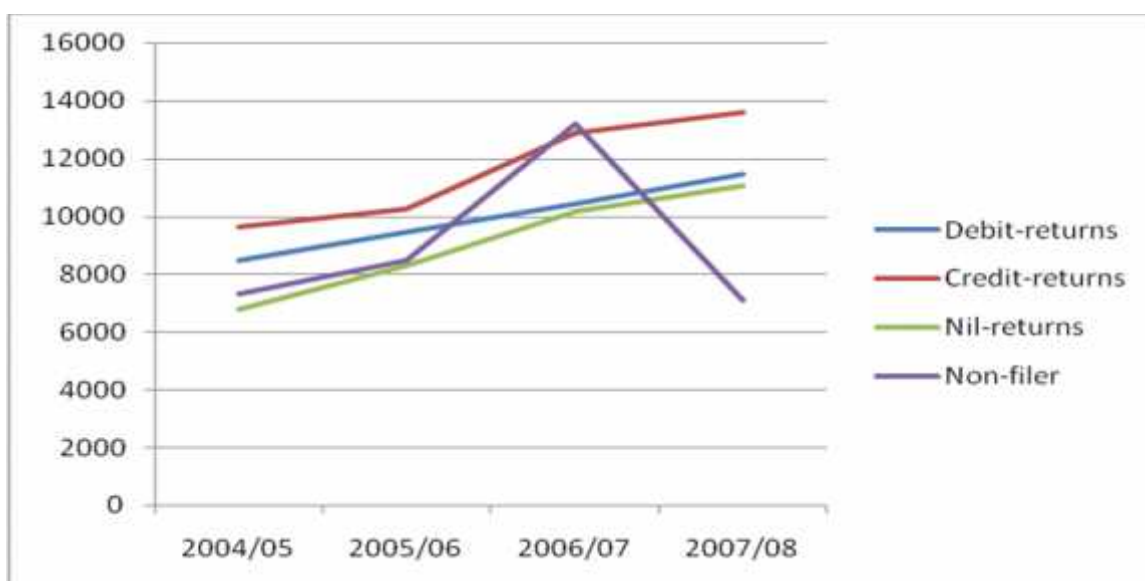


Table 4.15 and figure 4.6 shows that credit returns has increased in comparison to previous years. It means the government is increasing more liability of taxpayer. According to the VAT rule a taxpayer has the right to claim credit only when his purchases will exceed the sales of the month. Sluggish increase in debit returns, higher increase in credit returns and nil returns indicates either slack in business or lesser vigilances of tax administration in fields. Similarly increase in suspended returns and Non-filer reflects ineffectiveness of tax administration. There is not any data that can establish direct relationship to compliance through audit activities but these results are discouraging for IRD management.

#### 4.1.12 Tax Dues Status

The table 4.16 shows the tax dues statement in the fiscal year 2004/05 to 2007/08.

**Table 4.16**  
**Tax Dues Statement**

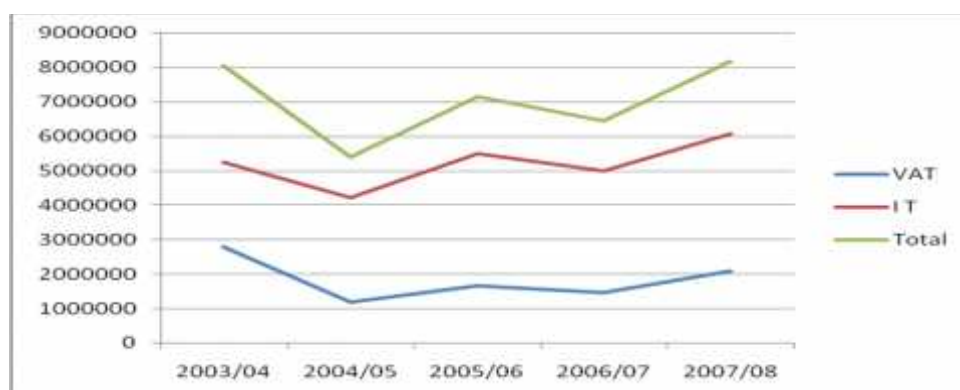
(Rs. in thousand)

Headings	2003/04	2004/05	2005/06	2006/07	2007/08
<b>VAT</b>	2794024	1185937	1662408	1468276	2089790
<b>I T</b>	5247078	4209363	5491111	4987262	6081743
<b>Total</b>	8041102	5395300	7153519	6455538	8171533

Source: Annual reports of IRD

Table 4.16 shows that trend of both the VAT & IT due has been fluctuating. Total dues in F/Y 2007/08 reached at higher than F/Y 2003/043 shows that income tax and VAT due collection is not taken as an important functions of tax administration in recent years.

**Figure 4.8**  
**Tax Dues Statement**



## 4.2. Primary Aata Analysis (Survey Data)

### 4.2.1. Analysis and Interpretation of Survey Data

The finding of survey data were tabulated and classified to make the use of statistical tools easy. Such data were categorized so as to meet the purpose. The findings of objective questions are as follow:

**Table 4.17**  
**Respondents**

<b>Name</b>	<b>Frequency</b>	<b>Percent</b>
<b>Tax officials</b>	25	100
<b>Business firms</b>	23	92
<b>Auditors</b>	22	88
<b>Total</b>	70	93.33

Source: Field Survey, 2009

Table 4.17 shows that out of total 75 questionnaires, tax officials have cent percent and all together 70 had responded. Out of 22 respondent auditors 4 were revenue auditors from OAG/N.

**Table 4.18**  
**Qualities of IROs Service**

<b>Indicator</b>	<b>Frequency</b>
Worse	2
Average	30
Good	12
Best	1

Source: Field Survey, 2009

Table 4.18 shows that 2 (4%) consider that the qualities of service are worse and only 12 (27%) considered the service are good. One respondent considers the qualities as best and majority (67%) take as an average service quality.

**Table 4.19**  
**Improvement of Service Quality of IROs**

<b>Indicator</b>	<b>Frequency</b>
Yes	29
No	16
Don't know	-
Don't response	-

Source: Field Survey, 2009

Table 4.19 shows that 29 (64%) respondent who are business firm and business auditors believe IROs improving its service qualities whereas 16 (36%) are not. Out of 16 respondents who rated services poor, 13 taxpayers (81.25%) perceived audit function as poor.

**Table 4.20**  
**Do You Know Audit**

Indicator	Frequency	Percent
Yes	20	86.96
No	3	13.04
Total	23	100

Source: Field Survey, 2009

Table 4.20 shows that 86.96% know what is audit and 13.04% do not have knowledge about audit.

**Table 4.21**  
**Overall Qualities of Tax Audit**

Indicator	Frequency	Percent
Very good	20	28.57
Fair	45	64.29
Worse	1	1.43
Don't know	4	5.71
No answer	-	-
Total	70	100

Source: Field Survey, 2009

Table 4.21 shows that 64.29 percent respondents rated overall qualities of tax audit fair and very good have got 28.57 percent only. No views has revealed by 5.71 percent.

**Table 4.22**  
**Tax Officers' Behavior During Audit**

Indicator	Frequency	Percent
Friendly & Cooperative	38	92.68
Suspicious	2	4.88
Rude	1	2.44
Total	41	100

Source: Field Survey, 2009

The table shows that majority of respondents favored for tax officials' behavior during audit.

**Table 4.23**

**Tax Officer's Honesty and Transparent in Tax Auditing Procedure**

Indicator	Frequency	Percent
Yes	19	42.22
No	5	11.11
No answer	21	46.67
Total	45	100

Source: Field Survey, 2009

Table 4.23 shows that 46.67 percent did not response about the honesty of officers and transparency in work while 42.22 percent favoured tax officials.

**Table 4.24**

**Present Rax Audit Targets**

Indicator	Frequency	Percent
Sufficient	19	76
More than expectation	5	20
Less than expectation	1	4
Total	25	100

Source: Field Survey, 2009

The above table shows that 75% officials are satisfied with present audit target.

**Table 4.25**

**Achievement of Tax Audit Targets**

Indicator	Frequency	Percent
Yes	21	84
No	4	16
Total	25	100

Source: Field Survey, 2009

The above table shows that 73.33 percent officials have finished their audit job in time; and 26.67 percent did not achieve their audit target.

**Table 4.26**

**Monthly Performance of Audit Target**

Indicator	Frequency	Percent
One	2	8
Two	6	24
Three	13	52
More	4	16
Total	15	100

Source: Field Survey, 2009

Table 4.26 shows that 16% performed tax audit of more than three taxpayers per month and 52 per cent has performed tax audit of three and 24 percent has completed tax audit of two only.

**Table 4.27**

**How Many Taxpayers Should be Audited in a Year?**

Indicator	Frequency	Percent
All	5	10.63
5% of total	33	70.21
10% of total	9	19.16
Total	47	100

Source: Field Survey, 2009

Table shows that 70.21 percent respondents favored for 5% of total taxpayers should be audited. 19.16 percent are in favor of 10% and 10.63 percent are in favour of 100%.

**Table 4.28**

**Taxpayer's Co-operation for Audit**

Indicator	Frequency	Percent
Yes	6	24
No	19	76
Total	25	100

Source: Field Survey, 2009

The table shows that only 24 percent of taxpayers have helped to conduct audit and 76 percent did not co-operate. According to tax officials, ignorance and non-compliance are the main causes for fewer co-operations.

**Table 4.29**

**Need of Competencies of Tax Auditors for Effectiveness of Audit**

Indicators	Frequency	Percent
Yes	40	85.1
No	-	-
Don't know	7	14.9
Total	47	100

Source: Field Survey, 2009

Above table shows that 85 per cent respondent felt need of competencies of tax auditor for the effectiveness of audit. Remaining didn't know about this matter.

**Table 4.30**  
**Competencies of Tax Auditors**

Indicators	Frequency	Percent
Inadequate	27	57.45
Fair	19	40.43
Enough	1	2.12
Total	47	100

Source: Field Survey, 2009

More than half respondents perceived present status of competencies is inadequate to perform the job of tax auditors. Only one respondent perceived enough.

**Table 4.31**  
**Effectiveness of Audit**

Indicators	Frequency	Percent
Yes	12	25.53
Less effective	5	10.64
No	22	46.81
Don't know	8	17.02
Total	47	100

Source: Field Survey, 2009

46 percent respondents had negative answer towards effectiveness of audit whereas 25 per cent had positive attitude on this.

#### **Causes for Ineffectiveness of Audit**

Out of 22 respondents, who believe audit is ineffective, 13(59%) people consider poor selection criteria is the main reason for it whereas 7(31%) people consider lack of competencies of tax auditors.

**Table 4.32**  
**Need of Separate Audit Policy**

Indicators	Frequency	Percent
Yes	18	62.07
No	10	34.48
Don't know	1	3.45
Total	29	100

Source: Field Survey, 2009

Out of 18 respondents who favoured for separate audit policy, 15(83.33%) respondents gave emphasis on both audit techniques and competencies of tax auditors.

**Table 4.33**

**Adequacy and Objectiveness of Selection Techniques**

Indicators	Frequency	Percent
Yes	23	79.31
No	4	13.79
Don't know	2	6.90
Total	29	100

Source: Field Survey, 2009

### 4.3. Major Findings of the Study

#### 4.3.1 Major Findings from Secondary Data

- **Total tax revenue collected / GDP:** The contribution of total revenue to GDP reached to 12.06 percentages in the year 2007/08 which is below the pre-determined target of three year interim plan though total revenue, tax revenue and inland revenue to GDP ratio is increasing trend.
- **Total Revenue Estimation/Total Revenue Collection:** GON succeeded to collect total revenue as per estimation in the fiscal year 2005/06 and 2007/08 but failed to achieve its target in the year 2005/06 and 2006/07. This estimation and collection doesn't represent tax gap as MOF makes estimation of total revenue as per need and incremental basis in spite of principles of measuring tax gap.
- **Number and types of tax returns/Number of registered tax payer:** In the VAT total registrants in the year 2005/06, 2006/07, and 2007/08 are 39776, 46831 and 52965 to the number of tax returns filed by 28525, 33633, 36457 respectively. The percent of non-filer is 21.43, 22.96 and 21.63 respectively. Higher and increasing number of credit returns is putting question on efficiency of tax administration. Decrease in non-filer in the year 2007/08 (14.58) has given somehow relief in this regard.
- **Additional taxes assessed through audit/tax liability declared:** The income tax assessed through tax audit is encouraging in recent year but VAT assessment is not satisfactory.

- **Tax dues:** The trend of both the VAT & IT due has been fluctuating. Total dues in F/Y 2007/08 reached at higher than F/Y 2003/04 shows that income tax and VAT due collection is not taken as an important functions of tax administration in recent years.
- **The taxpayer's selection for audit:** The taxpayer selection for audit is less than and around 2 percent that is far below five percent of international practice.
- **Audit target and achievement:** Achievement of target in Full audit, VAT zero return verification and TDS audit seems encouraging in F/Y 2007/08 in comparison to previous year but others weren't achieved. The research findings in developed countries as cited by Graham Holland in VAT monitor which is published for the Netherlands show that an Income tax audit or Investigation common for audit rates for audit is not less than 1 or 2 percentage of taxpayers a year and is rate for the rate to exceed 10 percentage. In VAT, once in 4 years in the United Kingdom, once in 5 years in New Zealand. The frequency of VAT audits on average tends to be higher than that for the income tax.
- **Tax assessment and Appeal:** MA of VAT is not satisfactory whereas Amended Assessment of Income Tax seems encouraging. 85.7 percentages of total assessed amount were not beyond dispute (2005/06) may put question on assessment & audit techniques. The percentage of appeal cases and amount is decreasing in recent years. It may be due the increase in effectiveness of audit of IRD but there might be the possibility of coalition and negotiation between tax auditor and taxpayers.
- **Staff Engagement:** The personnel involved in auditing works are 21.1 percentages of the total personnel of IRD and it has not changed since 2060. Majorities of audit staffs are officer level personnel.
- **Compliance through registration:** Though we can't establish direct relationship of registration compliance and tax audit, both PAN and VAT registrants are increasing in decreasing trend.
- **Revenue collection cost:** Revenue collection cost was decreasing till F/Y 2006/07 but highly increased to RS.16.38 in 2007/08 that was mainly due to increase in capital expenditure.

### 4.3.2 Major Finding from Questionnaire Survey

The summaries of survey findings are as follows:

- **Qualities of IROs service:** Majorities of respondent consider that the qualities of service are of average service quality but they believe that IROs improving its service qualities though the audit function as poor.
- **Overall qualities of tax audit and tax auditors' behaviour:** Most of the respondents rated overall qualities of tax audit fair though they favoured tax officers' behaviour during audit.
- **Tax officer's honesty and transparent in tax auditing procedure:** 46.67 percent did not response about the honesty of officers and transparency in work put question mark on honesty and transparency in tax auditing.
- **Present tax audit targets and Achievement:** Most of the tax officers were satisfied with present audit target and achieved it but they believed that taxpayers didn't cooperate during the audit.
- **Competencies of tax auditors and effectiveness of audit:** Majorities of respondents perceived that the present status of competencies of tax auditor is inadequate to perform the job and felt need of competencies for the effectiveness of audit. They believed audit was ineffective due to poor selection criteria and lack of competencies of tax auditors and showed concern on adequacy and objectiveness of selection techniques. They urged for separate audit policy.

# **CHAPTER V**

## **SUMMARY, CONCLUSION AND RECOMMENDATIONS**

### **5.1 Summary**

The inconsistency in the policy is the result of political indifference and lack of adequate mind application in the legislation brought for policy changes. In most of the cases, the politicians for political gain manipulate the tax policy and system and use to blame others for bad result. There is lack of clarity in fiscal vision and goals in macro level. The tax administration lacks of adequate autonomy that influences qualities and effectiveness of auditing. Provision of burden of proof on tax officer is good for creating responsibility & accountability but has negative impact on compliance behaviour of taxpayers.

There is not any provision to amend the return if the taxpayer feels he/she has filed incorrect return. The law does not have adequate provisions for investigations. For example, nothing is mentioned about taking suspected evaders in the custody of government. The section 111 of the IT Act has been made non-compliance cheaper than compliance. In the previous Act of 1974, the defaulters could be taken into custody for 6 months for not paying the dues. Prevailing Act has made provision to file case in the district court. There is no standard practice or policy that binds tax auditors to proven methods of case selection in field offices. Tax Settlement Commission: - Tax settlement commission has been formed for the clearance of tax return which is pending for tax assessment since very long time. Such practice is considered as mismanagement in modern taxation system.

A functional structure is more effective and also minimizes the direct contact between the taxpayer and tax officer. It also helps easily to reach a certain level of professionalism. If the functional structure is not implemented properly there will be some problems in reaching the overall objectives of organization. But in practice, it is found in that there are a lot of protests and obstructions internally and seems to be more in paper than in real terms. Representation of outsider in ACG

(FNCCI & ICAN) has made it handicapped as it can't discuss internal problems and recommend for which it is created.

The existing training program does not address the actual training needs of the IRD. These training deficiencies throw new light on the character and content of complaints by citizens, taxpayers, and practitioners that tax officers do not understand tax issues, business practices, or industries, and have a poor command of tax laws and of audit and accounting practices and procedures. IRD does not have a standard audit induction programme for new tax auditors. In addition, the performance management system is not being systematically used to identify the training and development needs of audit staff, tailor courses and opportunities to meet these identified needs, and follow up to check that the training is done. People's general perception is that employees are motivated to work under the Ministry of Finance. But all are not equally motivated to achieve their best in the job assigned to them. Employees' preferences to work under the Ministry of Finance originate in their desire to work in the area of their study, to get more opportunities in terms of foreign training and other could be the desire of quick enrichment. Even after quick enrichment, the probability of the detection and prosecution is low. The rate of conviction is lower than the rate of prosecution. There is no such thing as naming and faming. Some instances of naming and faming have not been exemplary in all respects. For example, people chosen for awarding medals and for civil service awards were not recognized as the best performers in their field.

At present, taxpayer compliance risk is measured based on the data mentioned by the taxpayer in his/her past two years' tax return. However, analyzing only two years' data might not predict the true picture of the compliance risk. On the other side, analyzing taxpayer's data record for more than two years is not easy manually and it needs advanced data base system and analyzing software that IRD lacks as well. Though VAT data are in computer system; most of the data related to income tax returns are still in paper only. In such situation, analyzing compliance risk associated to income tax is very difficult. There is no system of keeping third party information in the system that might be very useful for future examination and other purposes. In such situation, automated system cannot give the true picture of the risky taxpayers and the quality of the audit case selection can not be achieved.

## 5.2 Conclusions

The contribution of total revenue to GDP reached to 12.06 percentages in the year 2007/08 which is below the pre-determined target of three year interim plan though total revenue, tax revenue and inland revenue to GDP ratio is increasing trend. GON succeeded to collect total revenue as per estimation in the fiscal year 2005/06 and 2007/08 but failed to achieve its target in the year 2005/06 and 2006/07. This estimation and collection doesn't represent tax gap as MOF makes estimation of total revenue as per need and incremental basis in spite of principles of measuring tax gap. In the VAT total registrants in the year 2005/06, 2006/07, and 2007/08 are 39776, 46831 and 52965 to the number of tax returns filed by 28525, 33633, and 36457 respectively. The percent of non-filer is 21.43, 22.96 and 21.63 respectively. Higher and increasing number of credit returns is putting question on efficiency of tax administration. Decrease in non-filer in the year 2007/08 (14.58) has given somehow relief in this regard. The income tax assessed through tax audit is encouraging in recent year but VAT assessment is not satisfactory.

The trend of both the VAT & IT due has been fluctuating. Total dues in F/Y 2007/08 reached at higher than F/Y 2003/04 shows that income tax and VAT due collection is not taken as an important functions of tax administration in recent years. The taxpayer selection for audit is less than and around 2 percent that is far below five percent of international practice. Achievement of target in Full audit, VAT zero return verification and TDS audit seems encouraging in F/Y 2007/08 in comparison to previous year but others weren't achieved. The research findings in developed countries as cited by Graham Holland in VAT monitor which is published for the Netherlands show that an Income tax audit or Investigation common for audit rates for audit is not less than 1 or 2 percentage of taxpayers a year and is rate for the rate to exceed 10 percentage. In VAT, once in 4 years in the United Kingdom, once in 5 years in New Zealand.

The frequency of VAT audits on average tends to be higher than that for the income tax. MA of VAT is not satisfactory whereas Amended Assessment of Income Tax seems encouraging. 85.7 percentages of total assessed amount were not beyond dispute (2005/06) may put question on assessment & audit techniques. The percentage of appeal cases and amount is decreasing in recent years. It may be

due the increase in effectiveness of audit of IRD but there might be the possibility of coalition and negotiation between tax auditor and taxpayers. The personnel involved in auditing works are 21.1 percentages of the total personnel of IRD and it has not changed since 2060. Majorities of audit staffs are officer level personnel. Though we can't establish direct relationship of registration compliance and tax audit, both PAN and VAT registrants are increasing in decreasing trend. Revenue collection cost was decreasing till F/Y 2006/07 but highly increased to RS.16.38 in 2007/08 that was mainly due to increase in capital expenditure.

### 5.3 Recommendations

Audit policies and procedures should be based on principles of accuracy, efficiency, fairness, objectivity, transparency, completeness, consistency, and defensibility.

1. IRD should improve understanding of taxpayers' compliance and the effectiveness of compliance improvement programs **by developing a compliance-monitoring framework**. Such a framework, which can be progressively enhanced over time, should embody a range of measures and indicators for each of the major risk types for the major taxes administered by the IRD.
2. The IRD's strategy for taxpayer audit needs to be further developed to provide information and proposals to address the issues— in particular:
  - Improving the focus and conduct of audits;
  - Strengthening capability; and
  - Measuring and reporting performance
3. To make the tax system simple and understandable, present VAT & Income Tax Acts should be revised keeping in view of the tax compliance; particularly the provisions of burden of proof on tax officers make enforcement efforts of tax officers difficult. The effective tax law requires shift compliance's goal from mere enforcement to more proactive approaches that encourage voluntary compliances.
4. There is no provision to amend the return if the taxpayer feels he/she has filed incorrect return. IRD should give chances for taxpayers to make amendments by filing additional return; therefore they can reduce fee and penalty. Amending the existing law should provide this facility.

5. Enforcement activities should be combined with a commitment to taxpayer service. Policy positions and compliance proposals should be sensitive to taxpayer service and maintain an appropriate balance between enforcement activity and imposition of taxpayer burden.

### **Recommendation on MIS**

1. The IRD should review its technology strategy – including the range of tools required so that the principles identified in the audit strategy are implemented as a priority. The review should clarify the inter-relationships between MIS (Pro-Tax) technology and audit strategies, and ensure that they are implemented and monitored in a co-coordinated way.

2. IRD should enhance its database capacity so that it could be used in, including others, measuring the possible risk and future audit case selection process. Integrated computerized system (through LAN and WAN) that coordinates the data among the departments of MOF (DRI, Customs & IRD) has been the urgent need for the reliable and third party information.

3. It is recommended to IRD to take the computer processing system only for rough selection of taxpayers that might be some two or three times more than the real number of taxpayers to be audited and then make the final selection of the taxpayers by the highly skilled and experienced tax auditors by analyzing other different qualitative aspects too.

4. A team of technological expert including tax auditor should be created to obtain and address the growing field of e-commerce.

### **Recommendation on Audit Technique**

Presently tax auditors focus their effort on prohibited expense part of the income report. It should be changed to supervision of income part.

1. There is no proper segmentation of taxpayers before selecting them for the audit purpose. Keeping all taxpayers in the same basket and adopting it breaking line for each one to measure their compliance level is also not appropriate. Therefore, taxpayer rating system should be introduced for segmentation of taxpayers based on past audit performance and profile.

2. An arrear of audit case selection is increasing year by year. Tax personnel are not enough responsible toward current audit case selection job. So, there is a need of fundamental improvement in the current audit case selection system.
3. IRD should delegate full power of taxpayer selection for audit to the Chief of the field office. It is because the chief receives the first hand information of the taxpayers. S/he can analyze the information not only on the basis of the database but also on the bases the actual activities of the taxpayer. This will make chief of the office more responsible for the audit completion as well. Similarly, the chief should be responsible for explaining the reasons for the selection of every taxpayer. This will help tax officer on which aspect of the audit to be focused and taxpayer also can prepare his/her answer on the basis of the specific reason.
4. Historical audit experience should be retained, indexed, and published for the guidance of tax auditors on the conduct of future audits, and to provide them with background of the business and industrial practices in order to conduct effective examinations.

### **Recommendation on Human Resource Management**

Retention of competent staff is crucial. Without retention of competent staff tax audit activities will not achieve their objectives. Therefore, IRD should focus on its HR strategies.

1. IRD should identify and develop a system of capability / competency models in place that describes formal specification of the skills (including knowledge) that are required to perform audit work in a competent (i.e. efficient and effective) manner. The qualifications for recruitment of new tax officers need to be revised. Greater emphasis should be given to accounting training in an academic setting as opposed to obtaining candidates with economics or law degrees.
2. IRD should request to stop annual transfer of expert manpower by the Ministry of Finance without any logic to encourage professional efficiency of employees of all level. IRD should make the policy to retain the experts within the department. Frequent transfer of trained and experienced personnel within the functional section creates big a loss for the IRD and implementation of the modern tax. Such practices should be discouraged in order to enhance functional professionalism.

3. To create good working environment, the recruitment, transfer and departmental action and firing policy in revenue services should be rationalized.
4. Individual auditor capabilities should be assessed via performance evaluation against each audit team. IRD should prepare employee performance indicators and develop separate indicators for office as well as officials as requirement. Reward and punishment should be tied with these performance indicators. Present functional indicator can be used for this purpose.

### **Other Recommendations**

1. Audit and investigation working manual should be updated with the help of the team of experts. Working manual should be developed with international standard.
2. Specific segments of non-compliance should be targeted as per compliance model. For example a taxpayer belongs to upper half of compliance model should be addressed by audit & investigation functions whereas taxpayer belongs to lower half need taxpayer services.
3. The IRD should identify the case management requirements of taxpayer audit, and purchase and/or create tools to meet these requirements.
4. IRD should not have responsibility for tax cases. It should focus exclusively on prescribing policies and procedures for audit and monitoring audit in the field to ensure conformity and consistency.

The investigation section of IRD should be developed as Research & Development section for compliance activities. Alternatively, it can be developed as serious fraud investigation/detection wing.

1. Organizational structure of IRD should be revised keeping in mind of lean principle. Either 2<sup>nd</sup> class officer should be deputed as chief of field offices after restructuring present jurisdiction of those offices. Alternatively, DG of IRD should be converted into secretary level post.
2. The IRD should explore ways of assessing the impact of audits on taxpayer compliance. Public opinion surveys and other public opinion research should be used to understand compliance behavior and contributing influences.

3. Member of Audit core group should be revisited to eliminate representation of outsider in ACG (FNCCI & ICAN) .It should be developed as high level advisory team for auditing.

Result of audit & investigation should be published periodically that will help to produce demonstration effect on taxpayer compliance.

To sum up, there are a number of common pre-requisite features and requirements that need to be in place to ensure a good level of effectiveness and efficiency from audit activities and to support continuous improvement. They are:

- ) a comprehensive legal framework, including an appropriate regime of sanctions.
- ) Well-defined organizational and management processes, including a comprehensive performance measurement framework.
- ) Well-defined audit techniques and adequate support arrangements; and.
- ) Adequate human resource management and development programs.