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Case Study 2.2

**INCENTIVE AND COMPLIANCE FACILITATION MECHANISMS
BASED ON THE BEHAVIOR OF TAXPAYERS**

**General Directorate of Taxes
Costa Rica**

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Introduction

Perhaps in any tax scenario, but especially in those that could be considered “low compliance” or “generalized noncompliance”, the group of taxpayers that duly comply with their duties –regardless of their magnitude- should be given greater administrative attention. Said group constitutes an authentic “spearhead” whose preservation, first and subsequent eventual increase, could acquire strategic importance in the struggle against tax noncompliance.

Not only because of compliance with the material duty of making the corresponding tax payments, but also because of obligatory compliance with a series of formal duties which definitely make it more costly, compliant taxpayers are at a disadvantage vis-a-vis noncompliers, which frequently results in a significant competitive disadvantage. All of this within a context, at least in generalized tax noncompliance environments of null social recognition, not to say of a certain stigmatization, on perceiving noncompliance as an act of intelligence or skill of by the persons who incurs in it.

In view of this situation, the sustainability of the positive level of compliance achieved, regardless of its magnitude, appears as extremely fragile. And the undesirable effects, in relation to the goal –which is not less valid because of its difficulty- of increasing voluntary compliance or, of reducing noncompliance –in sum, two sides of the same coin— are easily evidenced. Something must be tried in order to eliminate or reduce said risk. More precisely, any or some incentives must be considered to support those positive behaviors.

Objective

It would appear strange even to think that due compliance with the constitutional duty of contributing to the payment of public expenditures, should be rewarded. If this were valid, would it likewise not be valid to reward honesty? In both cases, it is a matter of behaviors that serve as basis and render possible harmonious coexistence and, likewise, the viability of the organization and long-lasting existence of our societies.

Without the least intention of solving the controversy which, we recognize, is barely being raised, the justification, in the case of tax compliance could be in transferring to the compliant taxpayer the cost savings which his positive behavior could entail for the Administration and, through that means, attempt to reduce the “indirect tax pressure”. In other words, since taxpayer noncompliance involves enormous costs for the tax Administration, due to the actions that must be undertaken for correcting it, then it could be considered valid that those who fully comply may be entitled, through a series of “friendly” administrative procedures, to a reduction of their compliance costs.

In sum, the objective pursued on creating mechanisms for promoting and facilitating compliance based on the taxpayers' behavior, should be, first of all, to keep within the group of compliant taxpayers those who have shown appropriate behavior in their tax duties, through the implementation of mechanisms that may involve advantages vis-a-vis the noncompliers, and as second objective that on verifying such advantages, those who fail to comply may find motivations for moving in the direction of compliance.

Concept

The creation of advantages for a specific group of taxpayers could raise doubts about the respect that should be observed for constitutionally protected principles, such as fairness. Accordingly, the conceptualization of the group of taxpayers subject to the advantages to which we are referring, must be done as precisely as possible, by resorting to objective factors rather than indeterminate rhetorical formulas, in such a way that may be easily understandable by all taxpayers and especially, on the basis of such understanding, the right to enjoy the advantages granted may be requested by whoever fulfills such definition.

This scheme could not in any way be understood as gracious or graceful concessions of the administrative bodies. It is worth recalling that, like any other of the acts carried out by the tax administration, it would be acts of Public Law that must strictly abide by the law and, with its action being mainly focused on the verification of compliance with the established requisites by a specific taxpayer.

Thus, any taxpayer fulfilling the requirements –which must be determined through the normative instruments qualified for such purpose and officially published— would be entitled to the obviously, also normatively agreed advantages. In this way, one would also be solving the constitutional issue, since equal treatment would be afforded to all those who are in the same situation; that is, all those who are in the group of compliant taxpayers (horizontal equity) and in an unequal manner to those who are different; that is, compliant versus noncompliant taxpayers (vertical equity).

In sum, “compliant taxpayers” susceptible of obtaining the advantages agreed must be understood to be all those who comply with specific objective factors –who are listed in the following section- and which appear in the officially published appropriate normative media.

Tax Intelligence and Risk Matrix as objective elements for identifying taxpayers benefitting from compliance incentives

Tax intelligence, a process ever more used by the tax administrations to manage important information for controlling and defining on the basis thereof, risk profiles that may optimize the use of the always limited resources of the Administration, provides the necessary classification tools for objectively and equitably identifying the taxpayers that may benefit from the compliance incentives.

Although it is true that at the General Directorate of Taxation of Costa Rica we have been working for two decades in tax control issues with intelligence and risk criteria for selecting taxpayers to be audited, these criteria have been evolving through time with improvements in tax management that have been developed throughout the decade of the eighties in the past century. Particularly in the past ten years there has been significant computerized support for the management and processing of third-party as well as the taxpayer's own information. However, it was not until a few years ago that, within the framework of an ambitious project for the integral transformation of the country's tax management model, intensively based on digital government strategies, currently in the process of development and implementation that the issue of tax intelligence as source of administration of the information and taxpayer classification has been promoted for orienting with greater accuracy and transparency the efforts of the administration toward effectively complying with its mission.

This ambitious Project know as "Digital Taxation", considers in its fourth and last stage of implementation, scheduled for late 2009, the implementation of a "Tax Intelligence Model", wherein a Matrix of Risk Profiles is developed and, in relation to the issue that concerns us and by contrast, "Compliance Profiles" that will be the basis of identification of taxpayers subject to the incentives.

The risk matrix is conceptualized as a basic element of the tax intelligence component, created for the consistent, coherent, systematic and rational use of a series of risk indicators – that are assigned a weight – and which interrelated under mathematical and statistical formulas generate a series of characteristics or predictors that allow the tax administration to guide its efforts toward those sectors that represent the greater risk to efficient tax management, in general and processes, in particular, with a view to arriving at higher levels of collection.

The methodology for structuring it is based on the tax risk index (TRI), a figure applicable to 100% of the country's taxpayers, obtained from the weighting of the values achieved by a group of taxpayer economic-tax behavior indicators considered critical.

This figure acts as the taxpayer's global assessment and has the advantage of representing by means of a single value, the combination of the indexes that account for his tax behavior.

Tax risk is understood to be the probability that a taxpayer may declare less taxes than he should declare according to the economic and tax potential, his scale of production and operation and, likewise, his industrial and economic environment. In the risk matrix designed, initially the following risk zones have been identified:

- **Tax Compliance:** first general analysis intended to verify whether the taxpayer has correctly declared 100% of his self-assessment and/or informative tax obligations.

- **Consistency among taxes:** Analysis intended to verify the necessary consistencies with respect to the declared values, among related taxes. For example, the annual amount of sales declared in relation to the sales tax must be consistent with the annual sales item declared under income tax, for said tax period.
- **Consistency with third parties:** To the extent there is third party information relative to the taxpayer being analyzed, this area is aimed at verifying that both are consistent. For example, the sum of imports recorded by Customs in a given period must be consistent with the imports item declared under the Sales Tax, for that same tax period.
- **Consistency of each tax:** After concluding the foregoing analyses, this control zone continues to analyze the tax consistency of each of the returns filed.

The model identifies for each tax risk zone, one or several indicators that allow it to develop a global risk indicator, which applied to an algorithm for the measurement, will locate each taxpayer in accordance with his tax behavior.

For example, as many indicators as tax returns required for verifying taxpayer compliance would be designed for the tax compliance risk zone.

The structuring of the TRI begins with the definition of the series of tax risk indicators considered critical and which would be used in structuring the index.

Thereafter, a discrete scale of values is defined to weight the risk (for example, [0-1-2-3]), to then assign ranges to every risk variable that would locate it in one or another weighting factor. In this case, 0 represents no risk and 3 maximum risk.

An importance weight is subsequently assigned to every variable. It represents the level of importance of said variable in the taxpayer's risk.

Again a discrete scale of values is used to weigh each variable (for example [0 - 1]).

The tax risk index (TRI) is finally obtained through the weighted average calculated as the sum of the risk weighting factor achieved by each variable, multiplied by the weight of said variable. In order to establish an indicator that may be easily identified and evaluated, the number obtained is divided by the sum of the weight of each variable, multiplied by the maximum range of the scale of weights (in this case 3).

Finally, the formula is applied to each taxpayer, thereby obtaining a value of the TRI that is within the range of 0 and 1 and where the risk increases as the TRI increases with the maximum being in those taxpayers with TI 1.

Alternately, the “Tax Risk Matrix” is structured by grouping taxpayers with the same TRI, classified according to such dimensions as: taxpayer size, economic activity, geographical location, etc.

Such groupings with the dimensions determined, may be visualized by the users of the tax control areas, so that on the basis of the resulting data shown by the “Risk Matrix”, taxpayers may be selected in order to subject them to the required controls for improving their compliance.

With this same tool the Administration identifies taxpayers with optimum compliance according to their TRI, on which basis it may create “rewards” or tax incentives plans for their compliance. This is precisely the case that concerns us and provides us the objective classification tool for the granting of incentives.

Legal identification means:

The parameters for selecting compliant taxpayers, as well as the incentives to which they will be entitled, should be made known in a transparent and public manner.

It is important for taxpayers to be aware of their rights in this area and request them when they fulfill the conditions for obtaining them, thereby eliminating any risk of subjective favoritism, which may de-legitimize the objective pursued with this type of incentives.

The Tax Administration of Costa Rica has anticipated the incorporation of the incentives and criteria for identifying taxpayers entitled thereto, which have already been mentioned in the description of the risk matrix, in a general resolution published in the official gazette, so that they may be requested by those who believe they qualify according to these criteria and therefore have a right to the incentives

Legal basis and incentives for most compliant taxpayers in Costa Rica

The incentives provided in the Costa Rican legislation and which the Administration currently affords the most compliant taxpayers are the following:

Payment facilities with less requisites and longer terms.

Taxpayers who have shown sustained punctuality in filing their returns and paying their taxes, and for some special reason face some liquidity problem that prevents them from paying within the established term, are given a more favorable treatment than the rest requiring this type of facilities.

The legal basis for granting these facilities is found in the Code of Tax Regulations and Procedures, hereinafter the Tax Code, which reads as follows:

“Article 38.- Deferments and Installment Payments.

In cases and in the manner determined by the regulations, the Tax Administration may defer or divide the payment of the tax debts, including transferable taxes which may have not been collected to the end consumer and provided that the debtor’s economic-financial situation, duly proven before the administration may temporarily prevent him from paying on time.”

In addition, taxpayers who enjoy this benefit are exempted from the sanction for delinquency as provided in article 80 bis of the same law which reads as follows:

“...No sanction will be applicable and there will be no interruption in its calculation when the deferments and installment payments provided in article 38 of this Code are granted.”

These regulations, through regulatory provisions and procedures established by the Administration allow for providing a more favorable treatment to taxpayers considered as most compliant. In practice, the general rule is that, in order to grant these facilities, the applicant must make an initial twenty five per cent payment and pay the rest in six months. Nevertheless, the procedures provide that, for taxpayers with good compliance characteristics, the initial payment may be reduced to a much lower percentage and the term increased up to two years. In addition, there is greater flexibility in the guarantees requested, provided that they are based on good compliance

Tax discounts for taxpayers filing and paying through electronic means.

Undoubtedly the use of electronic means by the taxpayers significantly reduces costs to the Administration. In the Costa Rican case, this is considered in article 122 of the Tax Code which provides that *“...Regardless of the fact that the administration may order the obligatory use of these (electronic) means, it shall be authorized to grant, at its discretion, incentives to those who use them within a scale of discount percentages of the tax payable, differentiated according to taxpayer ranks whose maximum discount percentage cannot exceed five per cent”*.

This provision has been regulated through resolution of the Administration for taxpayers who use the electronic filing and payment means that have been available since 2002. Nevertheless, with the implementation of Digital Taxation it has been decided to render obligatory the use of electronic filing and payment, with a view to taking advantage of the legal discount power for stimulating new incentive schemes for compliant taxpayers that may be more in keeping with the needs of the Administration, within the framework of the new system.

One of the possibilities currently considered is to apply the discount to those who use electronic means and advance their filing and payment date, which would imply a lower flow of transactions on the tax filing expiration dates. In this way we continue to contribute to close the digital gap, in addition to reducing administrative processing costs.

Handling related inquiries within lower terms.

The Costa Rican law allows the taxpayer the possibility of consulting the Administration regarding the application of the tax law to a specific and current situation, through compliance with a series of requisites, as provided in article 119 of the Tax Code.

The Administration is allowed forty five working days to answer the inquiry and if upon expiration of such term it does not issue a response resolution the interpretation by the person making the inquiry must be understood as approved if the latter has explained it. In other words, “positive silence” is applicable in these cases.

The Administration has given instructions so that in the case of taxpayers with previously determined compliance characteristics, the forty-five day term be reduced to thirty days or less.

More expeditious resolutions and controls reduced to a minimum in the processing of refunds

Since taxpayers have a legitimate interest in being refunded as soon as possible, excess payments, either from withholdings or on account payment of taxes or value added tax, especially in the case of exporters, the Administration has instructed that procedures be more expeditious for those considered as compliant taxpayers. For example, the mean being four months, in the latter’s case, the procedure is concluded within a term that does not exceed two months. Even in those cases where previous verification of the origin of favorable balances is required, prior to making the pertinent refund, in the case of compliant taxpayers, instructions have been given to the control and verification offices so that verification actions be carried out within the shortest terms and scope possible. As a general rule, such verifications take place within an average three-month term, but instructions have been given so that in the case of compliant taxpayers, the term should not exceed two months. When it must be exceeded, previous authorization is required and the taxpayer must be duly informed.

Reducing sanctions when the taxpayer spontaneously rectifies any noncompliance or else, when detected by the Administration, the taxpayer promptly rectifies it.

It is obvious that if the taxpayer must rectify a noncompliance we are no longer faced with a typical “good compliant taxpayer”, but in keeping with what has been previously stated, in the section that describes the purpose of this document, incentives for due compliance should also constitute, for those who fail to comply a motivation for directing them toward compliance.

Article 88 of the Tax Code provides for discounts of up to eighty per cent of the administrative sanction for those who rectify and spontaneously self-assess the sanction.

The same article and in case the Administration may have detected noncompliance, provides for discounts of up to fifty five per cent for those who rectify their noncompliance and self-assess their sanction in the earlier stages of the administrative procedure.

Other mechanisms anticipated

The aforementioned mechanisms should not be seen as an end-product, but rather as an effort within a process of search for authentic means that may set a positive difference in favor of good taxpayers.

The Digital Taxation Project which, as indicated, is being implemented in 2009, will provide the technical bases for more effectively systematizing and organizing this process.

On the other hand, the Ministry of Finance of Costa Rica has placed high hopes on a national scope initiative which includes the three State Powers and other players from civil society, strongly promoted by the Presidency of the Republic. It is aimed at the design and implementation of a National Plan for the Prevention and Struggle against Tax Fraud and likewise, working groups in charge of measures of a preventive nature have been urged to propose the creation of other incentive mechanisms for the compliant taxpayer, as well as for strengthening the existing ones.

Conclusions

The group of good compliers has not been given adequate attentions by the tax administrations, especially in the countries with generalized noncompliance. The creation of mechanisms that favor them may be a form of compensation for that group so as to allow them to sustain such good compliance.

These mechanisms, as they imply unequal treatment could be seen as not legally viable. However, by correctly applying the principle of equity, which involves vertical and horizontal equity, they would fulfill the constitutional principle of equality.

Because of the obliged generality imposed by the application of the tax system, the mechanisms for identifying compliant taxpayers and the incentives to which they are entitled, must be clearly determined and published. The Costa Rican tax administration has focused its classification effort on the tax intelligence tools that allow for classifying taxpayers according to levels of risk and compliance. Incentives, on their part, are documented in provisions duly formulated and published. Each country will select the appropriate means for doing it, but worth noting is the importance in the formality of the procedures and technical and juridical arguments justifying them.

In Costa Rica, measures have been implemented, in practice, some legally authorized, others not requiring it, but which are definitely aimed at creating a difference in favor of good compliers.

Some of these mechanisms have required legal regulations, as is the case of discounts in taxes payable or the reduction of sanctions, both provided in the Tax Regulations and Procedures Code. For others, the administrative decision stipulated in rules and resolutions has been sufficient. In either case, they must not be seen as an end-product, but rather as a perfectible effort to find appropriate mechanisms that may create a difference in favor of good compliers and by means of such difference, not only try to ensure that good compliers may keep up their compliant behavior, but also attempt to attract non-compliers to this group.

In sum, it is a matter of endeavoring to correct the Administration's lack of attention to good compliers, who actually do not abound in our fiscal realities of low compliance. These taxpayers must feel that the Administration is close to them, recognizes their good behavior and promotes it. It is a way in which the traditional mission of the tax administration may evolve, from promoting voluntary compliance through service facilities and orientation, toward recognition of such good compliance, expressly materialized through specific incentives for said group.