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Case Study 2.2

INCENTIVE AND COMPLIANCE FACILITATION MECHANISMS BASED ON THE BEHAVIOR OF TAXPAYERS

Revenue Authority
Kenya

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Case Study 2.2: INCENTIVE AND COMPLIANCE FACILITATION MECHANISMS BASED ON THE BEHAVIOR OF TAXPAYERS

1. Background

The Kenya Revenue Authority administers various taxes including:

- Customs Duties
- VAT
- Income Tax
- Excise Tax
- Property (Real Estate) Tax
- Motor Vehicle Taxes – Purchase and Road Use
- Agency Taxes – on mutual agreement with other agencies

Tax administration functions include:

- Taxpayer registration
- Tax collection and debt management
- Tax compliance management including undertaking audits and issuing additional assessments
- Managing tax refunds
- Border security management.

Kenyan taxes are administered on self-declaration and self-assessment basis with audits being undertaken on selective basis. Customs management is coordinated with four other East African countries under the auspices of the East African Customs Management framework which provides for uniform practices.

2. Taxpayer Behaviour

In common with many developing countries, the KRA approaches tax administration within the context of several considerations including:

- Low level of automation – which curtails the ability to make inferences based on trends and group traits, two factors key in the understanding of taxpayer behaviour.

- Traditional approach geared towards enforcement – with great emphasis on audit as a tool for influencing taxpayer behaviour but effectiveness has been limited by resource availability and growing complexity of business and tax evasion/ avoidance schemes. As observed in many research studies, audit has only limited impact as a means of influencing taxpayer behaviour and similar considerations apply in Kenya particularly given very low audit coverage.

- Significant incidence of tax avoidance/ evasion with estimates of tax gap ranging from 15% to as high as 50% depending on the tax head.

- Weak tax risk management culture – compounded by inadequate database information, analytical tools and lack of a structured risk management framework.

The presentation therefore reflects the initial steps made in seeking to establish a coherent approach to tax administration using taxpayer behaviour and risk management techniques in a still significantly non-automated environment (work is in progress to implement an automated internet based tax management system with electronic filing having commenced in January 2009). It also reflects the priorities as seen from the KRA's perspective given resource and capacity limitations.

Understanding taxpayer behaviour

While no specific studies have been undertaken in Kenya to determine the drivers underpinning taxpayer behaviour, observations do point to factors similar to those documented in studies done elsewhere including:

- Risk of detection – for businesses this varies with the nature of transactions with higher compliance noted among well established entities that carry out trade "above board". Highest non-compliance is usually among informal businesses and those trading on cash basis. Organisational structure is therefore a major consideration in the prediction of taxpayer behaviour.

- The distilling of alcoholic spirituous beverages and water bottling serve as cases in point where low detection risk may negatively impact compliance behaviour among good taxpayers. In both sectors regular complaints are received especially from large taxpayers about a "tilted playing field" in which some players are seen not to comply, a fact which they claim renders their products to become less competitive. A few have openly "threatened" intention to follow suit as a means of ensuring business survival. Similar complaints against illicit imports are regularly recorded amongst large local manufacturers.

- Perceptions of equity – fairness considerations weigh heavily especially in matters concerning audit selection with large businesses perceiving themselves as being more intensely targeted. Perceptions also exist that some who do not play by the rules get away with it to the detriment of those who comply.

- A few instances have been detected where unpleasant past experiences with the tax authority have made certain taxpayers adopt a perpetually hostile attitude towards compliance. Recent debate in Kenya has also focused public attention on the discriminative tax status conferred on some benefits earned by certain public officers, a fact which has negatively impacted public perceptions about tax compliance.

- Perceived high rates of tax – there are perceptions (though not entirely accurate) that Kenya's tax rates are high and hence not business friendly. In some cases (e.g. excise duty), rates are seen as disproportionately higher in comparison with those in neighbouring countries.

- Complex legislation – a substantial proportion of audit adjustments result from what may be classified as "interpretation" issues, a fact underlining perceived complexities/ ambiguities in tax legislation. This area is now receiving closer scrutiny to align compliance behaviour with the attitude and flexibility exhibited in the resolution of tax disputes.

- Disputes centred on legal complexity have tended to create "bad blood" between the KRA and (especially large) taxpayers resulting in threats of, or actual filing of, legal suits. The downside is that the tax authority is seen as aggressive, unfriendly and one to be avoided.

- Public service delivery – concerns are routinely raised regarding government spending priorities and the value derived vis-a-vis the tax burden. It has become necessary to address this issue as part of the KRA's public education drive.

- Group and/ or individual characteristics – trends in behaviour point at unique challenges attributable to specific groups. Export and petroleum related tax refund claims exhibit higher fraud incidence while both sectors also exhibit consistently depressed profitability (the former attributed to transfer pricing and the latter to cost manipulation and product diversion).

3. Rewarding behaviour

There are a number of ways through which the KRA seeks to reinforce tax compliance behaviour with the general objective of projecting fairness in the tax administration process. Research studies have reported the building of trust to be among the most effective means through which voluntary compliance can be nurtured.

The mechanisms used fall into two categories namely:

3.1 <u>Positive reinforcement mechanisms</u>

These cover the following aspects:

- Tax refunds management
- Tax audit selection
- Waiver of tax penalties
- Customs clearance
- Taxpayer recognition scheme

3.1.1 Tax refunds management

Several parameters are utilized to discriminate between Low, Moderate and High Risk claimants. Among these (and their weights) are:

- Industry sector (0.1) – certain sectors exhibit higher fraudulent claims risk (exporters, oil companies).

- Nature of claim (0.1) – claims based on export transactions rated more risky than claims arising from VAT withheld and from normal transactions.

- Claims frequency (0.1) – more frequent claimants rated as less risky (but this notion currently under scrutiny based on recent experience).

- Past claims record (0.3) – based on audit results.

- Tax agent record (0.2) – based on experience with past claims and agents' own tax compliance.

- Tax compliance record (0.2) – corporation tax performance is especially significant with focus on tax yield (tax paid/turnover).

A general rule is to benchmark corporation tax performance to the perceived "best" performer in the sector and to generate audit queries on this basis. In some sectors (e.g. construction), independent professional standards are used to gauge profitability margins.

A weighted score derived from these parameters is utilized as the basis for either one of the following decisions:

- Pay without audit – below 0.30 (Low Risk)
- Pay and audit later – 0.31 to 0.65 (Moderate Risk)
- Audit before payment – above 0.65 (High Risk)

Claimant rating is undertaken quarterly and significant benefit has been recorded through speedier and more objective claims processing.

Some challenges encountered include:

- Developing a comprehensive measure for tax compliance that includes an assessment of the accuracy of tax filings.

- Developing reliable measures for certain quantitative and non-quantitative parameters (past claims record, tax agent reputation).

3.1.2 Tax audit selection

Until recently, audit selection was subjective with the rule of thumb being for each taxpayer to be audited once every three years. Audits also invariably covered all tax heads with no regard to taxpayer compliance behaviour either globally or on specific tax heads.

As earlier observed, indiscriminate audit selection engendered feelings of bias within sections of the taxpaying public with the system seen as penalizing the highly visible "deep pocketed" taxpayers through more frequent visits while the less visible and probably less compliant ones received less frequent visits. Risk based selection has enabled the linking of compliance behaviour with audit activity which among Kenyan taxpayers is seen as a not too pleasant exercise to be avoided to the extent possible.

The present methodology pools two factors:

Group factors – 0.3
Individual factors – 0.7

3.1.2.1 Group factors

This consists of factors common to the population including:

- Regulatory framework (0.1) – existence of structured regulation improves rating (banks, insurance firms, listed companies).

- Industry sector (0.4) – considers business complexity, nature of business transactions (cash/ non-cash ; export/ local), history of known cases.

- Listing/ incorporation status (0.3) – widely held, non-owner managed enterprises seen as low risk due to lesser incentive for private benefit.

- Auditor profile (0.2) - categorized on the basis of professional status (firm size, international affiliation, disciplinary record) and tax accuracy filing record.

3.1.2.2 Individual factors

This considers factors unique to the taxpayer including:

- Tax compliance (0.5) – measured against pre-determined revenue expectation, filing record and regularity.

- Financial performance (0.3) – using conventional indicators to detect unusual trends or “outliers”.

- Business complexity (0.1) – influenced by industry, nature of business and group structure.

- Auditor/ agent (0.1) – based on frequency of changes made which may be an indication of “auditor/ agent shopping”.

To further improve transparency of the process, communication on audit matters specifies in detail the grounds that led to selection.

The performance of the risk rating system in accurately prioritizing audit case load has yet to be assessed. An approach comparing the significance of audit adjustments made in the risk rated group against data from control groups (including a randomized sample) is favoured and forms part of planned research agenda.

3.1.3 Waiver of penalties

Remission of penalties considers the following behaviour related factors:

- Voluntary disclosure (0.5) – there is need to balance disclosure incentive against the potential to encourage evasion and delayed remittance of taxes where the remission is seen as too attractive. However additional consideration needs to be given where past compliance behaviour is rated positively, in order to ensure that the taxpayer is not disadvantaged by choosing to voluntarily disclose.

- Cooperation during audit (0.1) – willingness to accommodate audits and provide required information.

3.1.4 Customs Authorized Economic Operator (AEO) Scheme

The scheme facilitates expedited import cargo release for selected taxpayers based on the following equally weighted factors:

- Tax compliance – considering the broad tax context (among the major benefits of having Customs and Tax integration).

- Financial stability – based on conventional financial indicators.

- Control environment – by review of governance and internal control systems.

- Safety and security – risk associated with cargo type and input from other state security arms.

All AEOs are subjected to mandatory post clearance audits to discourage under-declaration. Plans are in progress to implement a risk based audit selection system.

3.1.5 Taxpayer recognition scheme

The scheme publicly acknowledges taxpayers who excel based on the following parameters among others:

- Absolute level of taxes paid.
- Corporation tax yield.
- Most improved tax remittance.
- Support to reform initiatives.
- Information sharing (especially on suspected tax evasion schemes).

No special tax or other incentives attach to this scheme but winners appear to value it as a complement to their CSR initiatives.

3.1.6 Public dealings

Access to the following government related privileges is contingent upon proof of tax compliance:

- Government contracts
- Government appointments

The range of privileges may be extended to include election into public office.

3.2 <u>Negative reinforcement mechanisms</u>

As mentioned at the beginning of paragraph 2, Kenya has a high incidence of tax evasion historically driven by a weak enforcement regime including the absence of stringent legal sanctions. In recent years action has been taken to strengthen the enforcement regime in the following ways:

- Including tax evasion among economic crimes – section 45(2) of the Kenyan Anti-Corruption Act states that a person is guilty of an offence under the Act if he:

> *"fails to pay any taxes or any fees, levies or charges payable to any public body or effects or obtains any exemption, remission, reduction or abatement from payment of any such taxes, fees, levies or charges".*

The maximum penalty for tax evasion under this law is one million shillings (equivalent to USD12,500) plus mandatory fine of twice the amount of tax evaded and/or ten years imprisonment. The law also provides for asset tracing.

- Introducing more stringent sanctions within revenue laws in respect of access to third party information, seizure of property, premises or bank accounts.
- Establishing a dedicated prosecution office within the KRA with state sanctioned prosecutorial power – this speeds up prosecution and guarantees better success rate.
- Publicizing tax evasion court cases

The framework is buttressed with an Information Reward Scheme that encourages the provision by members of the public of details that may lead to the detection of tax evasion schemes. A significant proportion of the information provided through this avenue comes from business competitors.

4. Conclusion

Linking taxpayer behaviour to tax administration response has helped build taxpayer confidence, direct resources more effectively and improve service delivery.

The main challenge however lies in the relatively minimal public appreciation of this linkage given the low level of dissemination of the schemes available and the benefits. Consideration is being given to publicising the assessment criteria to improve trust and public confidence.

There is the additional challenge of having to develop a corporate wide single viewpoint behaviour/ risk prediction model based on empirical data. The KRA is to create a dedicated corporate level function with the mandate to establish a risk management database in addition to promoting a unified approach to the understanding of taxpayer behaviour.

References:

1. OECD (October 2004), “Compliance Management: Managing and Improving Tax Compliance”
2. European Commission, “Risk Management Guide for Tax Administrations”
3. Kenya Revenue Authority (2008), “Risk Profiling Framework for VAT Refund Claimants”
4. Kenya Revenue Authority (Revised 2009), Risk Based Audit Cases Selection Framework”