

Options for Tax Reform

Country Y

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1 PREFACE

Income tax compliance is poor in Country Y. Of approximately 6,500 corporate returns issued to taxpayers in the 1999 tax year only about 3,000 were returned. The Tax Administration estimates its compliance rate in terms of returns filed at no more than 40%.

For some time now the authorities have had a stated objective to introduce income tax self-assessment as a means of increasing compliance. On the indirect tax side a draft VAT law has recently been published and it is envisaged that the VAT will replace the existing sales tax.

This document sets out to examine the current income tax law of Country Y in so far as it affects the main processes i.e.:-

- the filing of tax returns and raising of assessments,
- the payment, refund and recovery of tax, and
- the levying of penalties on taxpayers.

The document also discusses some perceived difficulties with the current income tax law and proposes recommendations for improvement.

If adopted these recommendations will lead to an enhancement of revenue as filing and payment procedures are simplified and penalties for non-compliance are made more comprehensive. Those taxpayers complying with the law will find it easier to file their returns and pay their taxes while those taxpayers not complying with the law will face a wider range of penalties and sanctions that will dramatically increase the costs of their non-compliance.

The proposals made herein dovetail with the “to be” processes currently being developed under the XY project. As a result of the recommendations made under this project, it is likely that the Tax Administration will need to change many of its processes and procedures. Because the Tax Administration operates within a strict legislative environment (the tax laws) changes in the law will be required to give effect to many of these procedural changes.

It is envisaged that this document and other outcomes from the XY project will lead to a full and frank discussion of the income tax law and procedures amongst all stakeholders, particularly tax administrators and tax professionals in the private sector. The result should be improved legislation and better processes within the Tax Administration leading to a marked increase in taxpayer compliance.

2 APPROACH AND STRATEGY

The initial point of departure of the 'XY' project was to assess the current reality of the Tax Administration and obtain a detailed and thorough understanding of its functions. This included the development of a strategic analysis under the following headings: -

- Strategy Formulation
- Legislative Environment – Background and History
- High Level Organisational Structure
- High Level TMS Architecture
- High Level Business Model

After evaluating the above, further work was performed to enhance the understanding of the functioning of the Tax Administration to a more detailed level. This work clearly identified the core processes and their objectives. The project is now at the point where re-designed processes are being presented to the various users and the senior management team.

This document proposes that in order for the Tax Administration to develop the most effective and efficient processes certain changes to the legislative environment will be necessary.

In analysing the current law and making recommendations it was felt advisable to adopt the following approach: -

- Simplify the flow of information into the Tax Administration as much as possible (e.g. self assessment, pooling assets for depreciation allowances, etc.),
- Remove anomalies in the current law and procedures (e.g. substituted accounting periods, benefits in kind not taxed at market value),
- Change work practices so as to eliminate time wasted on non-productive activities (e.g. processing directives),
- Remove opportunities for easy means of tax avoidance or abuse (e.g. pastoral farming losses being offset against PAYE income, additional training allowances),
- Provide simple and easy to use means of calculation (e.g. valuation of benefits in kind)
- Recognise the limits of tax administration and where possible shift all responsibilities for filing returns and paying tax to taxpayers,
- Reorient the activities of the Tax Administration towards control, auditing, and enforcement functions,
- Provide an effective penalties regime,
- Provide an effective auditing function, and
- Move the overall departmental structure towards a more functional structure that will support the new processes.

If adopted the recommendations made will greatly simplify many of the existing processes and procedures. In some cases it has been found necessary to make recommendations which impact on policy areas where a policy change may provide a huge administrative benefit.

An example of this is in the area of the filing of tax returns. The Tax Administration has as a stated objective the minimisation of the need for employees to file tax returns. This objective is very sensible assuming that most employees have only employment income and that the PAYE system of tax collection operates to recover the correct tax on that income. However many employees have interest income which is liable for tax at marginal rates but which is rarely reported. A simple policy change would be to impose a final withholding tax on interest at a reasonably low rate (10-15%) and then delete that interest from the tax filing obligation of individuals. In practical terms the Tax Administration would then only need to enforce a tax return mainly from individuals with business income, thus eliminating a huge portion of administration work.

Re-drafting the law will provide a huge impetus and direction for the introduction of more efficient processes and the preparation of new forms and procedures. It is strongly recommended therefore that the authorities move quickly to initiate the re-drafting of the income tax law in order to provide the Tax Administration with the required legislative framework.

3 RETURNS, PAYMENTS AND PENALTIES

3.1 Returns and assessment

3.1.1 Brief outline of current law

Part X of the income tax law deals with the obligation of filing returns and notices and Part XI deals with the making of assessments.

Returns must be filed within 2 months of the end of the tax year. The Commissioner is obliged to give notice in the Gazette when returns are required and the Tax Administration sends out blank return of income forms to the taxpayers on its records.

The Commissioner has the power to: -

- Request additional returns
- Request information returns from third parties,
- Enter any premises at any time of the day or night, and,
- Seize retain and copy any books records or accounts.

Business taxpayers must submit their accounts with the return. Companies are obliged to submit returns of dividends and interest paid and to provide annual lists of shareholders. The Commissioner may extend the time period for the filing of a return. In practice if the period of the extension exceeds the end of the calendar year, the Tax Administration may demand that the taxpayer file a provisional return.

Section 24 provides that taxpayers may make up their accounts for the tax year or for a period of 12 months ending on a date within the tax year (substituted accounting periods). However the obligation to file a return is linked only to the tax year and not to the accounting period. The return filing period is two months after the end of the tax year so a taxpayer making up accounts to say 31 July (one month inside the tax year) would not have to file a return until 31 August in the following year i.e. 13 months later.

Section 70 obliges business taxpayers to file their accounts and a computation of the chargeable income along with the return. Taxes are assessed on the basis of the return and accounts submitted.

The Commissioner is obliged to assess every person chargeable with tax as soon as possible after the expiration of the period allowed for filing the return. The Commissioner may accept the return and make an assessment or where a return has not been filed or the Commissioner is not satisfied with the return filed, the Commissioner may make an assessment to the best of the Commissioner's judgement.

After the assessment is issued a taxpayer has 60 days to lodge an objection. The objections process is a two-stage process with a further appeal to the Board of Adjudicators or the High Court being permitted. The objections and appeals process supposedly does not halt the collection of tax.

3.1.2 Discussion of current law

The returns procedure acts to delay the collection of tax. There is little point in taxpayers filing returns and then having to wait for the Tax Administration to review the returns, prepare an assessment, issue the assessment and then seek to collect tax on the assessment. Taxpayers, particularly corporate taxpayers, can easily file the tax return (which should include a calculation of the tax due) along with a cheque for the payment of the tax. These taxpayers may be audited at a later stage but the tax according to their calculations will have been remitted much faster than is currently the case. This procedure is generally referred to as self-assessment¹.

It is unfair for some taxpayers to be expected to file their returns within two months of the end of the tax year, while others can take up to 13 months merely by changing their accounting date. Furthermore this amounts to an unacceptable loss of revenue as the combination of the substituted accounting period, the return filing period and the time taken to issue an assessment may easily be as much as 20 months from the time the income arose.

A two-month filing period is extremely short and could easily be extended to three months, particularly if the anomaly above is removed from the law.

It appears that there is no practical sanction against a taxpayer who refuses to comply with a request for an information return other than possibly for an information return in respect of withholding taxes.

It is difficult to see how the Tax Administration may collect the entire tax owing on assessments that are under objection. It is probably better to provide in the law for collection to proceed only in respect of the tax that is not in dispute with an interest penalty where the tax paid is inadequate in regard to the eventual liability. Apart from the hardship that may be imposed on a taxpayer from collecting more taxes than should be payable, such a provision creates a demand from taxpayers for the payment of interest on overpaid taxes. Interest on overpaid taxes should be avoided as it allows the possibility for taxpayers to invest in the tax system at what would likely be relatively high interest rates.

¹ Greater detail on self assessment (including an implementation timetable) is provided in the XY Project Document entitled "Preparation for Self Assessment", a discussion draft of which was presented to the Tax Administration on 22 December 2000.

Recommendations

Consideration should be given to: -

- Amending the law to allow for the self-assessment of corporate taxpayers,
- Extending the return filing period to 3 months,
- Linking the filing of a tax return to the end of the accounting period, not the tax year,
- Ensuring that there is a substantial penalty for failure to provide information as requested under section 68,
- Providing that only tax not in dispute be collectible until the objection is settled with a suitable interest penalty for underestimation of tax not in dispute, and
- Ensuring that interest does not become payable on overpaid tax.

3.2 Payment, Recovery and Refund of tax

3.2.1 Brief outline of current law

The law dealing with the payment, recovery and refund of tax is contained in Part XIII of the income tax act (sections 94 to 114).

Tax is payable 30 days after service of the notice of assessment. The Commissioner may grant an extension of time for payment and allow for payments by instalment. Interest on unpaid tax is charged at 1.5% per month or part of a month during which it remains unpaid. Tax deducted by employers or other withholders is due within 15 days of the end of the month in which it was withheld. Withheld tax attracts interest at the rate of 2% per month during the period that it remains unpaid. The law contains the usual provisions regarding tax owed by persons about to leave Country Y, the priority of tax debts, the recovery of tax from representative taxpayers and the recovery of tax from persons holding money on behalf of tax defaulters.

The Commissioner may seek to recover tax from assets of the spouse of a tax defaulter but only where there is evidence of a transfer of assets with the intention of avoiding the payment of tax.

Sections 112, 113 and 114 deal with the computation and payment of tax during the current tax year.

3.2.2 Discussion of current law

To allow for self-assessment and best international practice income tax should be due and payable on the date on which the return of income is due. The existing rule should remain for the circumstances where tax is assessed.

The existing power of the Commissioner for granting an extension of time for payment of tax is too broad and invites abuse. At the very least the taxpayer should be obliged to make the request in writing and specify good cause for requesting the delay. Interest should run from the original due date.

There is no power of closure (either temporary or permanent) of businesses for non-compliance with tax obligations.

There is no power of distress that would allow the Commissioner to seize and ultimately sell the assets of defaulting taxpayers.

Spouses are associated persons and it is reasonable for the law to allow for the recovery of tax from the spouse of a person married within community of property

without having to prove that the assets were transferred between the spouses to avoid payment of tax.

There appears to be no provision dealing with the obligation of receivers to advise the Tax Administration of their appointment or no provision preventing receivers from disposing of assets without the prior written consent of the Tax Administration. Such provisions are necessary to enforce the Tax Administration's preferential claim on the assets of insolvent persons or persons in liquidation under section 109.

The obligation to pay income tax in quarterly instalments is good international practice. However the procedures are cumbersome and there are too many obligations placed on the Commissioner. For example why is it necessary for the Commissioner to designate each company by notice in writing? Surely it is simpler to provide that all companies pay tax by instalments? The obligation to compute an accurate instalment payment should be placed solely on the taxpayer and, as with the current law, there should be an interest penalty where the taxpayer's instalments are shown to be inadequate. The Commissioner should not be involved in estimating or accepting computations of instalment payments as this is the responsibility of the taxpayer.

Following on from the recommendation in the previous section that the filing of a tax return should be linked to the taxpayer's accounting period and not to the tax year, it will be necessary also to link the instalment payments to the accounting period. This should have the added advantage of producing a more even flow of tax revenue during the tax year.

3.2.3 Recommendations

Consideration should be given to: -

- Making tax due and payable on the date by which the tax return is due as the primary rule,
- Providing that requests for deferment of payment of tax be in writing and be obliged to show good cause,
- Granting the power to the Commissioner of closure of a business where there is persistent non-compliance,
- Granting the power of seizure and disposal of business assets to the Commissioner where other recovery methods may have failed or may be inappropriate,
- Removing the obligation of proof of tax avoidance in relation to assets of spouses married in community of property,
- Obliging receivers etc. to advise the Commissioner of their appointment and seek written authorisation prior to disposing of assets,
- Streamlining the instalment of tax procedures to remove the Commissioner's involvement in designating companies or in agreeing instalment payments,

- Effectively penalising taxpayers for inadequate payment of instalment tax and
- Instalment tax to be due and payable in accordance with the accounting period and not the tax year.

3.3 Offences and penalties

3.3.1 Brief outline of current law

The law relating to offences and penalties is contained in Part XIV of the income tax act. Division 1 provides for penalties which may be imposed at the discretion of the Commissioner (which are in addition to any penalties arising from criminal proceedings) and Division II which provides for criminal proceedings. Criminal proceedings are brought by the Attorney General in the name of the Commissioner.

The offences listed in Division 1 are: -

- Failure to furnish a tax return (section 116),
- Failure to furnish a correct return or estimate of taxable income (section 117), and
- Failure to appoint a public officer, precedent partner, agent or address for service of notices (section 118).

The offences listed in Division II are: -

- Breach of secrecy (section 119),
- Failure to comply with the requirements of the act (section 121),
- Intent to evade liability to tax (section 122),
- Offences by employers (section 123),
- Offences by employees (section 124),
- Failure to deduct tax from certain payments (sections 125 and 126), and
- Aiding and abetting an offence.

Section 10 of the Income Tax Amendment Act 1998 added new penalties to a wide range of withholding offences.

3.3.2 Discussion of current law

The separation of penalties into two categories is an excellent feature of the law as the Tax Administration must have the power of imposing speedy and effective sanctions on defaulting taxpayers without the need to go to court. For the achievement of good taxpayer compliance it is vital to have a penalties regime which is comprehensive (covers all the main offences), contains effective sanctions (so that taxpayers know they must comply) and has a speedy means of delivering the sanction.

At first sight the penalties regime appears fairly comprehensive. However there are a number of areas where the law may be improved in order to enhance the Tax Administration's ability to apply effective sanctions against defaulting taxpayers.

A taxpayer failing to file a tax return may be liable to a penalty of 2% per month on the amount of tax charged for that tax year plus a further penalty equal to the amount of tax chargeable for that year. The penalty is calculated from 30 days after the due date for filing the return up to either the date of the assessment or 30 days after the return is eventually furnished. The Commissioner has the power to impose a further penalty of P500, which may be mitigated when the return is eventually filed.

Encouraging taxpayers to file their tax returns accurately and on time is the most important feature of any tax system. The current law does not deliver an effective sanction in this case because the penalty is based on the eventual liability for the year and thus it cannot be imposed until such time as that liability is decided. This could be years after the filing date. It is submitted that the most effective penalty for this type of offence is the immediate imposition of a substantial monetary fine followed by a daily penalty where the offence persists. This is immediately comprehensible to taxpayers.

The perceived disadvantage of a monetary fine is that the value of the fine is eroded over time by inflation. Another factor is that the fine has to take account of the ability of taxpayers to pay the fine. Therefore it is suggested that: -

- The fine be set at a relatively high value, say **10,000,
- The fine be reviewed in the light of inflation every 3 years,
- The Commissioner be given the power to impose a lesser fine on smaller taxpayers but with a floor amount of, say, not less than **1,000, and
- The Commissioner be required to publish the list of fines annually.

In addition the range of penalties which the Commissioner may levy needs to be greatly expanded. A table setting out a suggested list of penalties is provided in Table 1 overleaf. It is worth noting that the penalties suggested are fairly consistent with those proposed in the Value Added Tax Bill, 2000 that was published on 14/11/2000.

While section 118 requiring the appointment of public officers etc is useful, the penalty provided is ineffective (**10 per day) [Note why wasn't this amended when section 117 was amended to include a penalty of **100 per day or 1% of the tax due??]. This needs to be increased as suggested below but perhaps keeping the daily penalty. However more importantly a link needs to be created between offences committed by the company or partnership and the public officer or precedent partner as the case may be. The individual concerned should be made responsible for tax obligations imposed on the entity. The Commissioner should be able to appoint public officers etc where the entity has failed to do so and charge public officers personally with corporate offences unless they can prove that they were unaware of the offence. The Commissioner should only appoint public officers who exercise real managerial control in the entity.

In order to produce an effective penalties regime and also to streamline the Tax Administration's procedures in this regard, it is suggested that the following strategy be developed: -

- Rationalise all the penalty provisions (e.g. why have a penalty for failure to give access to books and records for withholding taxes but not for income tax on profits?),
- Substantially increase the list of offences to which Division 1 applies,
- Division 1 penalties to be levied by the Commissioner as at present with the main sanction being a substantial fine plus an additional daily amount in certain cases,
- Division II penalties to also provide for a substantial fine plus a term of imprisonment,
- The Commissioner to retain the power to levy interest charges under Division 1 in addition to the penalties provisions but for an expanded list of offences, and
- The Commissioner have the power to appoint public officers who are individuals having managerial control.

Table 1. Division 1 penalties [may not be comprehensive] to be discussed with Tax Administration in a workshop]

Offence	Suggested penalty
Failure to file a return or document ²	Up to **10,000, plus an appropriate daily amount for continuation of offence.
Failure to keep proper records	Up to **10,000
Knowingly keeping false records	Up to **20,000
Failure to obey notice from Tax Administration requiring a person owing money to taxpayer to pay that money to Tax Administration for offset against taxpayer's tax debt.	Up to **10,000
Failure to withhold tax, either employee withholding tax or other withholding tax.	Up to **20,000
Failure to pay tax withheld.	Up to **20,000
Providing false withholding tax certificates	Up to **20,000
Failure to provide reasonable facilities and assistance to auditors in the examination of books or records at taxpayer's premises	Up to **10,000
Failure to comply with request for information from Tax Administration	Up to **20,000
Knowingly using a false Taxpayer Identification Number	Up to **20,000

² This would include all returns i.e. tax returns on profits, returns of employee emoluments and information returns.

Making false or misleading statements to a tax officer or omitting items from a statement that are material to that statement	Up to **20,000
Obstructing tax officers in the course of their duties	Up to **20,000
Failure to appoint a public officer, etc or advise Tax Administration of appointment as receiver	Up to **10,000

In addition to the penalties specified above the Tax Administration must also be able to levy interest in respect of a range of specified offences. Delays in compliance whether arising from the failure to file returns, pay taxes or delay payments by spurious appeals contribute to a real loss of revenue. To combat these practices it is normal to impose a charge for the revenue lost as a result of the delay in the payment of tax.

The interest charge should be imposed automatically, especially for the primary offences of failing to file a tax return, pay tax on time and for withholding tax offences.

There will probably be a need for the remission of interest penalties in whole or in part in certain circumstances. Therefore the Commissioner needs to retain the power to remit interest penalties. The circumstances should be decided in advance and published by the Commissioner so that the remission of interest is confined only to clearly defined exceptions.

A suggested list of interest penalties is provided below.

Table 2. Division 1 interest

[Note the specified rate is currently 2% per month, which seems appropriate given the prevailing interest rates in Country Y]

Offence	Interest and additional tax
Failure to file a return	Interest at the specified rate calculated on the tax payable from the date the return was due until the return is properly filed.
Failure to pay tax on time	Interest at the specified rate calculated on the tax unpaid from the date on which the payment was due until the date it is paid.
Failure to pay over tax withheld on time	Interest at the specified rate imposed on the withholding agent in respect of tax not withheld from the date that the tax should have been withheld. Interest may also be imposed where tax has been withheld but not paid over.

Failure to pay estimated tax upon receipt of extension of time to file return or underestimation of tax upon extension of time to file return	Interest at the specified rate calculated on the deficiency of tax from the date the payment was due.
Failure to maintain proper records as required by law. ³	Additional tax of double the amount of tax payable for the year of assessment in which proper records are not maintained.
Making false or misleading statements to a tax officer or omitting items from a statement that are material to that statement ⁴	Additional tax of double the amount of tax lost as a result of the false or misleading statement or from the item omitted.

It is suggested that the penalties brought under criminal proceedings be increased as follows.

Table 3: Division II criminal proceedings

Offence	Suggested penalty (on conviction)
Failure to file a return	Up to **20,000 or imprisonment of up to 6 months, or both fine and imprisonment
Failure to keep proper records	Up to **20,000 or imprisonment of up to 6 months, or both fine and imprisonment
Knowingly keeping false records	Up to **40,000 or imprisonment of up to 2 years, or both fine and imprisonment
Failure to obey notice from Tax Administration requiring person owing money to taxpayer to pay that money to Tax Administration for offset against taxpayer's tax debt.	Up to **20,000 or imprisonment of up to 2 years, or both fine and imprisonment. Upon conviction the courts should also force compliance with the original notice.
Failure to withhold tax, either employee withholding tax or tax due from international payments as suggested.	Up to **40,000 or imprisonment of up to 2 years, or both fine and imprisonment
Failure to pay tax withheld.	Up to **40,000 or imprisonment of up to 2 years, or both fine and imprisonment
Providing false withholding tax certificates	Up to **40,000 or imprisonment of up to 2 years, or both fine and imprisonment
Failure to provide reasonable facilities and assistance to auditors in the examination of books or records at taxpayer's premises	Up to **20,000 or imprisonment of up to 6 months, or both fine and imprisonment
Failure to comply with request for information from Tax Administration	Up to **40,000 or imprisonment of up to 6 months, or both fine and imprisonment

³To be imposed by the Commissioner as an alternative to a prosecution for criminal proceedings under Division II.

⁴ To be imposed by the Commissioner as an alternative to a prosecution for criminal proceedings under Division II.

Knowingly using a false Taxpayer Identification Number	Up to **40,000 or imprisonment of up to 2 years, or both fine and imprisonment
Making false or misleading statements to a tax officer or omitting items from a statement that are material to that statement	Up to **40,000 or imprisonment of up to 2 years, or both fine and imprisonment
Obstructing tax officers in the course of their duties	Up to **40,000 or imprisonment of up to 2 years, or both fine and imprisonment
Failure to appoint a public officer, etc. or advise Tax Administration of appointment as receiver	Up to **20,000 or imprisonment of up to 2 years, or both fine and imprisonment.

3.3.3 Recommendations

Consideration should be given to: -

- Adopting the penalties strategy as described above,
- Empowering the Commissioner to levy a wide range of penalties and interest under Division I as shown in the tables above,
- Continuing to allow the Commissioner to remit interest in whole or in part but obliging the Commissioner to publish guidelines indicating when the power of remission may be exercised,
- Increasing the range of penalties that attract criminal prosecution under Division II as shown above,
- Making company officers personally liable for corporate offences, and
- Commissioner to appoint public officers where entity fails to do so.

4 TAX BASE

4.1 General

This part of the report deals only with some important aspects of the tax base insofar as they impact negatively on the processes and procedures of the Tax Administration. Making the changes that are recommended here will: -

- remove many opportunities for tax avoidance,
- allow the Tax Administration to simplify many of its procedures, and
- improve the collection of tax revenue.

It should be noted that this part of the report is not an exhaustive review of the current tax base of Country Y.

4.1.1 Brief outline of current law

Part III of the income tax act deals with the imposition of the income tax on the various classes of income. These are: -

- business income, which includes farming and mining,
- employment income, and
- other income such as interest, royalties, entertainment, management and consultancy fees, etc.

4.1.2 Discussion of current law

The law takes income from all classes including gains on disposal of property into gross income. The sum of gross income from all sources, less exempt income is referred to as assessable income. Assessable income less allowable deductions produces chargeable income and the sum of chargeable income from all sources (other than capital gains which are taxed separately) is taxable income upon which tax is levied.

The main income classes are not quarantined and as a result taxpayers are able to offset losses from one class against income in another. The most serious example of this is the practice of offsetting pastoral farming 'losses' against employment income which normally produces a large repayment of PAYE tax withheld. For many individuals the entire tax withheld under the PAYE system is refunded. This practice is extremely popular in Country Y and the Commissioner receives about [15,000] refund claims per annum. Moreover the type of activity being conducted here is akin to hobby farming or part-time farming. The procedure is wide open to abuse as current practices within the Tax Administration do not even demand the production of original records for expenses claims.

This is a serious defect in the income tax law of Country Y and has the following effects: -

- considerable revenue is lost,
- considerable resources of the Tax Administration are tied up in wasteful activities,
- the PAYE system which operates to collect tax on employment income is thus seriously undermined, as the authorities are going to the trouble and expense of deducting tax merely to hand it back upon receipt of a claim for a farming loss, and
- transparency within the tax system is lost.

4.1.3 Recommendations

Consideration should be given to: -

- amending the law so that business losses (including farming losses) may only be carried forward against business income and not set against employment income, and
- Tax Administration to introduce more stringent procedures in relation to farming loss offset claims e.g. demanding full expenses verifications and introducing tests to determine if a real business is being conducted.

4.2 Employment income

4.2.1 Brief outline of current law.

As mentioned above employment income is a component of gross income. Employment income is broadly defined under Section 31 of the income tax act to include wages, salaries, etc and benefits in kind. Employment income is subject to tax by withholding (PAYE) and the rules regarding withholding are contained in the fifth schedule to the income tax act. Under paragraph 3 of the fifth schedule the amount of tax that should be deducted is determined in accordance with tax tables prescribed by the Commissioner.

4.2.2 Discussion of current law

The authorities have a stated policy of continuing in their efforts to make the PAYE tax a final tax and in this regard benefits in kind were recently made subject to PAYE. However the law continues to oblige employers to seek directives from the Tax Administration before proceeding with exceptional payments such as bonuses, gratuities, etc. This obligation, which stems in part from the non-cumulative nature of the PAYE system, imposes a huge burden on the resources of the Tax Administration, which receives about 10,000 such applications per annum. Because bonuses etc cannot be paid until the directive issues, the Tax Administration is placed under considerable pressure to deal quickly with these requests. As a result little or no resources are available for the more important work of policing the PAYE system and ensuring that stop-filers/stop payers are quickly identified.

Most employees in Country Y are employed by employers whose payroll systems are computerised and who can easily compute the precise tax due from a variety of payments. Even those employers who are not computerised should be capable of computing the tax due from exceptional payments. It is recommended therefore that the law be amended so that employers are not obliged to consult the Tax Administration each time an exceptional payment is due to an employee. For those employers not using computerised payroll systems the Tax Administration should revise the Employer's Guide to include detailed instructions for dealing with exceptional payments. The Tax Administration could also consider making a spreadsheet available for employers and perhaps publishing this on a website (see section 5 below).

Marginal tax rates in Country Y are relatively low with a top rate of 25%. The personal tax structure is somewhat rate heavy with 5 rates ranging from 5% to 25%. Progressivity in taxation could just as easily be achieved with two or three rates. Tax bands that are wider and divisible by 12 would make the tax calculation simpler for employers. It is recommended that the personal rate band structure be changed to at most a three-rate structure and that the tax bands be widened and made divisible by 12.

The law taxes the more common benefits such as accommodation, furniture, utilities, vehicles, and low interest loans. Free medical attention and free passages by air, road or sea for an employee and his family are exempt benefits.

There are two cardinal rules with regard to the taxation of benefits in kind. Firstly, benefits in kind must be taxed at the market value of the benefit received. If benefits in kind are not taxed at market values then employers and employees will structure employment contracts so as to maximise payments in kind over cash payments. This will ultimately lead to distortions in the tax system and more work for the Tax Administration. Secondly, the rules for calculating the value of benefits in kind must be made as clear and as simple as possible so that employers are facilitated to include the value of benefits in employees' taxable remuneration without the intervention of the Tax Administration.

The two main benefits currently provided in Country Y, cars and accommodation, are seriously under valued in relation to market values, although the rules provided for their calculation do partly satisfy the ease of calculation test.

Vehicles costing over **150,000 are taxed at **7,500 plus 15% of the excess over **150,000 whereas vehicles costing between **24,000 and **150,000 are taxed between 4-5% of cost. This rule is simple enough but there is then a confusing and unjustified fuel cost adjustment calculation that is unnecessary. There is really no argument for taxing vehicles at the lower end of the market at a lower rate than other vehicles. Taxing all vehicles at a flat 15% of cost contains an in-built bias towards smaller more economical cars since the value of the benefit is lower on smaller and cheaper cars. It is recommended therefore that for ease of calculation and approximation to real values that all vehicle benefits be taxed at 15% without a fuel cost adjustment.

Taxing accommodation in relation to rateable valuation is fine so long as realistic and fair rateable valuations are comprehensive and available in all cases. However the multiplier of 6% clearly values accommodation at less than its true value which should approximate to market rent. It is recommended therefore that the 6% multiplier be increased to make the accommodation benefit approximate to market values.

While exempting medical benefits paid by the employer is justified, the policy objective is defeated by the failure to specify that the benefit be available to all employees on equal terms. The existing law allows an employer to provide for the medical expenses of the directors while ignoring the medical expenses of other employees. It is recommended that the exemption be available only when provided to all employees on equal terms.

Similarly the free passage exemption (which is a carry over to colonial days) is drafted too loosely. There is no effective cap on the class or costs of travel, when employees may travel (every year, every two years?) or to where they may travel. Thus employment contracts may easily be structured to include tax-free holiday travel instead of salary. It is recommended therefore that this benefit be either abolished or capped in terms of cost and availability.

The Tax Administration should prepare a comprehensive list of all benefits currently available in Country Y and publish clear guidelines for employers regarding the valuation and taxation of these benefits. [Note: what's missing?? Meals, entertainment, debt waivers, domestic assistants (how taxed??)]

4.2.3 Recommendations

Consideration should be given to: -

- Continue the policy of making PAYE a final tax,
- Remove requirement for employers to seek directives before making exceptional payments to employees,
- Tax Administration to revise Employer's Guide to include withholding instructions on exceptional payments and make a spreadsheet available on disk and on website,
- Change personal rate bands to 3-band structure with wider tax bands divisible by 12,
- Benefits in kind to be taxed at market values,
- Rules for the calculation of benefits in kind to be kept as simple as possible,
- For cars, make 15% rule applicable to all vehicles and abolish the fuel adjustment,
- For housing keep existing RV system but change multiplier to reflect market values,
- Medical benefits should only be exempt when available to all employees on equal terms,

- Free passages to be taxed or capped in terms of cost and availability, and
- Tax Administration to prepare and publish a comprehensive list of benefits and rules for the calculation of taxable values of benefits

4.3 Interest income

4.3.1 Brief outline of current law

Interest is taxed under section 32 of the income tax act in respect of sources arising or deemed to arise in Country Y. Resident individuals are exempt from **2,500 of interest payable by a bank or building society.

4.3.2 Discussion of current law

Dividends paid by a resident company to a resident individual are subject to a withholding tax under section 57. Apart from business or rental income the other significant source of income accruing to individuals is interest. Making interest subject to a final withholding tax would bring a significant tax administration benefit as the withholding obligation would be placed on a small number of payers (banks and companies). Interest arising in Country Y and subject to withholding could then be made exempt in the hands of individuals, thus obviating the need for returns to be filed in respect of interest income. The rate of withholding should be low (10-15%) in line with the rate applicable to dividends. A low withholding rate combined with a final tax would allow for the abolition of the **2,500 exemption.

4.3.3 Recommendations

Consideration should be given to: -

- Making interest paid domestically subject to a final withholding tax at a low rate, and
- Abolishing the **2,500 exemption on interest.

4.4 Capital allowances

4.4.1 Brief outline of current law

Under section 40 of the income tax act a deduction is allowed in respect of capital expenditure. The rules for computing capital allowances are contained in the third schedule to the income tax act. Taxpayers may claim an initial allowance of 25% on industrial buildings and an annual allowance of 2.5%. The annual allowances applicable to other assets may be set by the Commissioner at rates between 10% and 25% having regard to the expected life of the assets. The annual allowances are computed on the 'straight line' method and balancing charges may be rolled over and set against the cost of new assets instead of being brought to charge in the year of disposal.

4.4.2 Discussion of current law

The capital allowances regime is generally quite good but some changes are necessary. Many assets (notably aircraft and heavy plant) have very generous depreciation rates well in excess of their useful lives. Allowing a roll over on balancing charges does nothing to encourage investment in new plant but does produce unnecessary administrative complications. Currently used claim forms are in need of revision and the Tax Administration has difficulty in tracking assets and ensuring that capital allowances are not claimed more than once for the same asset.

The Commissioner should consider revising the rates of annual allowances to reflect realistic expected asset lives and perhaps grouping assets into three or four broad groups. Allowing the grouping of assets would greatly ease the calculation of capital allowances.

4.4.3 Recommendations

Consideration should be given to: -

- Revising depreciation rates to reflect real economic life of assets,
- Grouping assets into three/four groups to facilitate pooling, and
- Abolishing rollover of balancing charges.

4.5 Additional Training Allowances

4.5.1 Brief outline of current law

Section 43 of the income tax act provides a deduction of 200% in respect of training expenditure incurred during the tax year on expenditure approved by the Commissioner in accordance with rules that are prescribed from time to time.

4.5.2 Discussion of current law

Training expenditure incurred for the purposes of training employees of a business is a normal business expense and would fall to be fully deductible in any event. Presumably the allowance of 200% is an effort at providing some sort of an incentive to encourage businesses to train citizens, perhaps as part of a wider 'localisation' policy.

While training and localisation are always perceived as good things it is submitted that the tax system is an inappropriate vehicle for the pursuit of these policy objectives. Placing an incentive like this in the law serves to invite abuse and create additional areas of control for the Tax Administration. Closely held companies will be tempted to hire family members and of course training will be conducted abroad leading to claims for air tickets and hotel expenses to be treated as part of training expenses. The Tax Administration will be unable to police these claims and will be

unable to determine whether the purpose of training held abroad is actually for training and not for other motives such as holidays.

Removing this provision of the law will produce benefits in terms of revenue collected and tax administration and will allow the Tax Administration to utilise the resources spent in this area to more productive uses.

4.5.3 Recommendation

Consideration should be given to: -

Withdrawing the additional allowance for training expenditure so that training is only deductible as to 100% of expenditure actually incurred for the purposes of the business.

5 ORGANISATION

In its drive for greater efficiency the Tax Administration is set to undergo a period of significant change. Many of the recommendations made in this paper will greatly simplify the administration of the tax but will also demand a different response from the Tax Administration. The Tax Administration is currently re-evaluating its organisational structure and the move towards a structure based on function rather than on tax type is under consideration.

The proposals for the introduction of self-assessment and for increasing the obligation for employers to withhold the correct tax from employees will demand an effective audit capability within the Tax Administration. Currently the Tax Administration has little or no audit capacity and a major challenge for the organisation will be the creation and deployment of an effective audit section. Training assistance will be necessary and a risk based auditing programme will need to be developed. It is vital that taxpayers become aware of the possibility of returns being audited and sanctions applied for non-compliance.

The Tax Administration has a significant problem with the recruitment and retention of suitably qualified staff. Currently staff vacancies amount to about 17% of the total establishment. Again, while many of the recommendations made here will allow for the deployment of staff to more productive areas of work, the Tax Administration will need to ensure that it is capable of recruiting and retaining quality staff, particularly for audit work. In order to recruit staff of the right calibre the Tax Administration will need to revise its rewards structure and provide better career opportunities for its staff. The Tax Administration should explore all means of providing a performance related rewards structure to its staff.

The Tax Administration will need to embark on a taxpayer education programme to educate taxpayers regarding self assessment in particular and taxpayer compliance in general. The Tax Administration will need to utilise all media, newspapers, magazines, radio and television for this campaign and should integrate the internet into its taxpayer education programme. A website should be prepared and taxpayers should be able to download forms and access Commissioner's rulings and other vital information from the website.

5.1.1 Recommendations

Consideration should be given to: -

- Moving the Tax Administration towards a more functional organisation structure,
- Creating, training and deploying an effective audit section,
- Introducing a performance based rewards structure for staff of the Tax Administration,
- Developing a taxpayer education programme,
- Creating an internet site for the Tax Administration, and
- Integrating the internet into the taxpayer education programme.

6 SUMMARY OF RECOMMENDATIONS

The following is a summary of the recommendations made in this paper.

No.	Recommendation	Comments
1	Amending the law to allow for the self-assessment of corporate taxpayers	
2	Extending the return filing period to 3 months	
3	Linking the filing of a tax return to the end of the accounting period, not the tax year.	
4	Ensuring that there is a substantial penalty for failure to provide information as requested under section 68	
5	Providing that only tax not in dispute be collectible until the objection is settled with a suitable interest penalty for underestimation of tax not in dispute	
6	Ensuring that interest does not become payable on overpaid tax	
7	Making tax due and payable on the date by which the tax return is due as the primary rule	
8	Providing that requests for deferment of payment of tax be in writing and be obliged to show good cause	
9	Granting the power to the Commissioner of closure of a business where there is persistent non-compliance	
10	Granting the power of seizure and disposal of business assets to the Commissioner where other recovery methods may have failed or may be inappropriate	
11	Removing the obligation of proof of tax avoidance in relation to assets of spouses married in community of property	
12	Obliging receivers etc. to advise the Commissioner of their appointment and seek written authorisation prior to disposing of assets	
13	Streamlining the instalment of tax procedures to remove the Commissioner's involvement in designating companies or in agreeing instalment payments	
14	Effectively penalising taxpayers for inadequate payment of instalment tax	
15	Instalment tax to be due and payable in accordance with the accounting period and not the tax year	
16	Adopting the penalties strategy as described in section 3	

No.	Recommendation	Comments
17	Empowering the Commissioner to levy a wider range of penalties and interest under Division I	
18	Continuing to allow the discretion to remit interest in whole or in part but obliging the Commissioner to publish guidelines indicating when the power of remission may be exercised	
19	Increasing the range of penalties that attract criminal prosecution under Division II	
20	Making company officers personally liable for corporate offences	
21	Commissioner to appoint public officers where entity fails to do so.	
22	Amending the law so that business losses (including farming losses) may only be carried forward against business income and not set against employment income	
23	Tax Administration to introduce more stringent procedures in relation to farming loss offset claims e.g. demanding full expenses verifications and introducing tests to determine if a real business is being conducted	
24	Continue the policy of making PAYE a final tax.	
25	Remove requirement for employers to seek directives before making exceptional payments to employees	
26	Tax Administration to publish withholding instructions on exceptional payments for employers using manual systems. Tax Administration to make spreadsheet available on disk and on website.	
27	Change personal rate bands to 3-band structure with wider tax bands divisible by 12	
28	Benefits in kind to be taxed at market values	
29	Rules for the calculation of benefits in kind to be kept as simple as possible	
30	For cars, make 15% rule applicable to all vehicles and abolish the fuel adjustment	
31	For housing keep existing RV system but change multiplier to reflect market values.	
32	Medical benefits should only be exempt when available to all employees on equal terms	
33	Free passages to be taxed or capped in terms of cost and availability	
34	Tax Administration to prepare and publish a comprehensive list of benefits and rules for the calculation of taxable values of benefits	

No.	Recommendation	Comments
35	Making interest paid domestically subject to a final withholding tax at a low rate	
36	Abolishing the **2,500 exemption on interest	
37	Revising depreciation rates to reflect real economic life of assets	
38	Grouping assets into three or four groups to facilitate pooling	
39	Abolishing rollover of balancing charges	
40	Withdrawing the additional allowance for training expenditure so that training is only deductible as to 100% of expenditure actually incurred for the purposes of the business.	
41	Moving the Tax Administration towards a more functional organisation structure	
42	Creating, training and deploying an effective audit section	
43	Introducing a performance based rewards structure for staff of the Tax Administration	
44	Developing a taxpayer education programme	
45	Creating an internet site for the Tax Administration	
46	Integrating the internet into the taxpayer education programme	