Review of the Tax Audit Framework in the National Tax Administration

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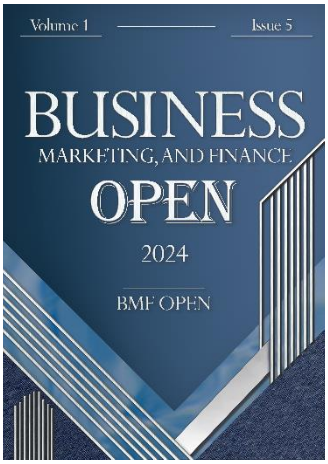

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Abstract: This study examines the perspective of the National Tax Administration regarding tax auditing and the concepts of compliance and non-compliance with tax laws. Tax compliance is defined as adherence by taxpayers to tax obligations and regulations (full compliance), while tax auditing is aimed at reconciling the information provided in tax returns, financial statements, accounting records, and taxpayer documents with relevant laws, regulations, and the administration's information databases. In contrast, non-compliance is interpreted as tax evasion and avoidance. One of the primary objectives of tax authorities in all countries is the collection of taxes with minimal administrative costs through compliance and full adherence to tax laws. Therefore, the dominant strategy for tax management is to encourage taxpayers' voluntary tax payments by increasing their trust in the tax system and reducing compliance costs. However, in the tax collection process, some taxpayers, either deliberately or negligently, fail to fulfill their obligations due to weaknesses in the tax administration and certain deficiencies in tax laws and regulations. Although completely eradicating this phenomenon in any country's tax system is almost impossible, many tax administrations, with full awareness of this reality, continuously seek to reduce and minimize instances of non-compliance through the design, implementation, and enforcement of risk management programs and mandatory regulations.

Keywords: Tax Audit, Tax Compliance, Tax Evasion, Tax Avoidance

1. Introduction

Accounting profit is calculated based on accounting standards, whereas taxable income is determined according to tax laws. Although income and expense recognition for tax purposes often aligns with accounting standards, differences exist between the two. Tax compliance and non-compliance have led to discrepancies between actual tax revenues and estimates. Therefore, research topics include tax compliance and non-compliance, their measurement, influencing factors, and outcomes. Non-compliance occurs within a specific range, either legally or illegally, to take advantage of tax benefits, encompassing tax avoidance and tax evasion. Generally, there are no robust or effective laws to control legal non-compliance, resulting in many companies engaging in such practices. Identifying the factors influencing non-compliance in companies is therefore significant [1-3].

In financial literature, companies' legal efforts and strategies to reduce tax costs are referred to by various terms, including tax management, tax avoidance, and aggressive tax practices. Commonly, tax avoidance activities are tools for tax savings, shifting resources from the government to the company. However, aggressive tax planning, often designed to conceal facts and prevent detection by tax authorities, can increase financial ambiguity within companies [4-6].

Due to the differing rules for calculating taxable income and accounting profit, discrepancies arise between the two figures. Consequently, accounting profit is adjusted to convert it into taxable income. In some cases, these differences are influenced by tax evasion or avoidance. Tax avoidance relates to finding loopholes in tax laws or seeking legal means to reduce tax liabilities. As tax avoidance represents a sustained financial strategy encompassing entirely legal activities, it may involve actions such as directing business resources toward tax-exempt activities, timing transactions to benefit from tax advantages, or employing accounting methods that yield greater tax savings [7-10].

In contrast, tax evasion is distinct from tax avoidance in terms of legality. Tax evasion is an illegal and informal act involving deliberate misrepresentation or deception. Laws impose penalties for tax evasion upon detection, whereas tax avoidance, being a legitimate commercial activity, cannot be nullified by judicial or tax authorities. Transactions under tax avoidance are real, and no stringent regulations prevent such activities. The question of whether tax avoidance within the bounds of the law, regardless of ethical considerations, is acceptable remains a critical issue [11-13].

As noted, the conceptual distinction between tax evasion and tax avoidance pertains to the legality of taxpayers' behavior. Tax evasion is a legal violation where a taxpayer refrains from reporting income subject to taxation, resulting in informal and illegal practices that evade government and tax authorities' scrutiny. Conversely, tax avoidance stems from weaknesses in tax regulations, where individuals seek loopholes to minimize tax liabilities [4, 14]. As a seemingly legal activity, tax avoidance is more visible than tax evasion. In other words, tax avoidance constitutes formal exploitation of tax laws [11, 15].

The broader concept of tax planning examines all legal frameworks for tax planning, covering a spectrum from full compliance to complete non-compliance. Consequently, the degree of compliance reflects the potential adherence to the tax system. This study examines the perspective of the National Tax Administration regarding compliance and non-compliance within Iran's economic environment.

2. Methodology

This study is based on a comparative review of tax laws and regulations. Specifically, key provisions affecting tax reporting and the calculation of taxable income were extracted from enacted laws and regulations to establish a foundation for examining the legal principles governing tax auditing. Analyzing these legal provisions provides a general overview of tax auditing and its implications.

3. The Concept of Tax Compliance

One of the primary goals of tax authorities worldwide is to collect taxes with minimal administrative costs while ensuring full compliance with tax laws. A dominant strategy in tax management involves encouraging taxpayers to voluntarily fulfill their tax obligations by enhancing their trust in the tax system and reducing compliance costs.

Despite these efforts, some taxpayers, either deliberately or due to negligence, fail to meet their obligations due to weaknesses in tax administration or flaws in tax laws and regulations.

Although completely eradicating non-compliance in any tax system is nearly impossible, many tax authorities, recognizing this reality, continuously seek to reduce or minimize non-compliance through the design and implementation of risk management programs. Consequently, improving compliance via compliance risk management programs has become a core component of tax management in developed countries. The primary elements of compliance risk management include identifying risks, assessing and prioritizing them, analyzing taxpayer compliance behavior, and developing strategies to address these risks.

In developed countries, compliance risk management is implemented either as an independent managerial approach or as part of a strategic program within tax organizations. Most countries pursuing continuous compliance improvement utilize organizational structures centered on compliance management. These structures align tax management with compliance management, effectively making tax management synonymous with compliance management. Organizational designs in these countries often focus on segmenting taxpayers into groups with shared characteristics to facilitate compliance management [9, 16].

Although Iran's tax system is not yet designed for compliance management, fundamental actions informed by international experiences are underway. Every country has a specific taxable capacity, corresponding to its maximum collectible taxes, based on existing economic activities. The gap between potential and actual tax revenues, often due to taxpayer non-compliance through evasion or avoidance, is known as the tax gap [9, 16].

Taxpayer non-compliance, leading to the tax gap, is influenced by various factors, including structural problems within the tax system and economic, social, psychological, and cultural factors. Modern tax management approaches focus on improving compliance to reduce the tax gap by implementing compliance risk management programs aimed at minimizing the likelihood of inaccurate reporting. The estimated tax gap can sometimes be broken down into components such as tax avoidance, fraud, partial non-compliance, errors, and overdue liabilities [17].

The concept of tax compliance, often studied from the taxpayers' perspective, is rooted in the theoretical framework of expected utility maximization. According to this theory, taxpayers will avoid paying taxes when the costs of compliance (including tax payments, time, and associated expenses) outweigh the benefits of non-compliance. In such cases, the likelihood of taxpayer detection and enforcement actions by the tax authority become critical determinants of compliance behavior [18, 19].

Numerous studies have defined tax compliance. For instance, the Australian Tax Office (2009), the Inland Revenue Board of Malaysia (2009), Jackson and Milliron (1986), and Kirchler (2007) define tax compliance as the willingness of taxpayers to adhere to laws, accurately report income and expenses, and pay all taxes on time (Pillai, 2001).

James and Alley (2002) propose that tax compliance can be understood from different perspectives, such as individual or organizational willingness to act in accordance with tax principles and laws. McBarnet (2003) identifies three types of compliance: voluntary compliance, enforced compliance, and innovative compliance. Voluntary compliance refers to taxpayers willingly fulfilling their tax obligations without resistance. Enforced compliance involves taxpayers fulfilling obligations due to pressure from tax authorities. Innovative compliance encompasses actions taken by taxpayers to legally reduce their tax liability through creative reinterpretation of taxable income and expenses [16, 20].

Kirchler (2007) suggests that compliance may be voluntary or imposed. Voluntary compliance arises from mutual trust and cooperation between taxpayers and tax authorities. Conversely, distrust and lack of cooperation lead to conflicts, requiring authorities to enforce compliance through audits, penalties, and other measures. Non-compliance refers to taxpayers' deliberate or unintentional failure to meet tax obligations, manifesting in various forms such as intentional misinterpretation of laws or errors in applying tax rules [21, 22].

Overall, tax compliance represents taxpayers' adherence to tax obligations and laws, serving as a benchmark for assessing a country's tax system efficiency. In some sources, tax compliance is defined as the degree to which individuals or organizations comply with tax laws. According to Brown and Mazur (2003), tax compliance is a theoretical and multifaceted concept comprising timely payment compliance, filing compliance (timely submission of tax returns), and reporting compliance (accurate reporting of tax liabilities) [19, 23].

The OECD tax compliance model (2010) categorizes taxpayers by their willingness to comply, ranging from full compliance to complete non-compliance. Tax authorities, in turn, respond to taxpayer behaviors by employing strategies such as audits, penalties, guidance, education, legal reforms, and procedural adjustments. The ultimate goal of these diverse strategies is to encourage more taxpayers to adopt compliant behavior, thereby reducing reliance on strict enforcement measures and lowering administrative costs.

Financial data analysis is a practical approach for measuring tax compliance, involving comparisons of financial performance indicators over time or across taxpayer groups through vertical and horizontal analysis. This method helps predict non-compliance likelihood. For example, measures like the tax rate, the ratio of taxable income to accounting profits, and taxable income to total income can be used, though challenges remain in isolating and quantifying factors influencing taxpayer performance [24].

The concept of corporate compliance within tax regulations is explicitly mentioned in the Direct Tax Code. According to Article 190, paragraph 1, taxpayers fulfilling legal obligations such as timely submission of returns, financial statements, and payment arrangements are eligible for penalty exemptions. In general, tax compliance is defined as adherence to tax obligations and laws, while tax audits aim to verify the alignment of taxpayers' reported information with regulations and official records.

4. The Concept of Tax Management

A key measure to improve tax compliance through implementing compliance-enhancing tools is tax management. Tax management is significant both for individuals concerned with the critical role of increasing tax revenues in achieving macroeconomic balance and for those interested in tax policies and their broader economic impacts. As noted by Tanzi (1987), tax management plays a fundamental role in establishing an effective tax system that aligns with legal tax systems.

There is a growing belief among tax policy experts in developing countries that changing tax policies without reforming tax management is meaningless. Therefore, tax policy changes must align with the capacity of tax management. In developing countries, tax management is effectively synonymous with tax policy.

Optimal tax management is not solely about maximizing tax revenue; it also considers how revenue is collected, including its impact on tax fairness, political consequences for governments, and effects on economic welfare. Weak tax management may result in significant tax collection from easily accessible sources, such as wage earners, while failing to collect taxes from businesses and corporations [4, 5].

Thus, the level of tax revenue collected is a simple metric for assessing tax management efficiency. A more precise measure is the degree of compliance, represented by the gap between potential and actual tax revenues, and how this gap varies among different taxpayer groups [25-27].

Richard M. Bird (1992), in his study of tax management practices among members of the Inter-American Center of Tax Administrators, emphasized that an essential prerequisite for reforming tax management is simplifying the tax system to ensure effective implementation in low-compliance environments typical of developing countries. Bird highlighted the necessity of a strategy for successful tax management reform [28, 29].

A comprehensive strategy involves prioritizing tasks based on available resources. Bird argued that no universal strategy applies to all countries and situations. Thus, successful tax management reform requires strong commitment and interest from policymakers and managers, as well as a minimum level of technical capability. Even the best reform strategy in the simplest tax system will fail without political support from top government officials and a team of committed managers. Regarding the role of tax management in compliance, its goal is to create conditions that encourage voluntary compliance, rather than solely focusing on penalizing tax evasion. Effective compliance incentives are achieved when management anticipates and addresses non-compliance through detection and penalties. Progress in taxation depends on effective management, which should not be confused with efficient management. Efficiency may reduce tax collection costs but might not foster compliance. Effective tax management is an essential, though not sole, determinant of voluntary compliance, particularly in countries with high non-compliance rates.

5. The Concept of Tax Avoidance

Tax avoidance and evasion fall within the broader concept of tax non-compliance. According to Kio et al. (2017), non-compliance refers to taxpayers' negligence or failure in completing tax returns, reporting liabilities, or accurately calculating and paying taxes. This includes intentional and unintentional errors stemming from a lack of tax knowledge or disregard for proper reporting, encompassing all forms of tax avoidance and evasion.

Paying taxes reduces profits and cash available for other stakeholders, such as shareholders, creating a natural incentive for companies and their shareholders to engage in tax avoidance. Dyreng et al. (2007) define tax avoidance as the ability to pay minimal income taxes relative to pre-tax profits, often achieved by limiting information flow to prevent tax authorities from identifying liabilities [25, 30].

Research by Chen et al. (2011) and Kim et al. (2010) indicates that tax avoidance negatively impacts companies' informational environments. Avoidance often involves complex structures allowing managers to manipulate performance metrics (Desai & Dharmapala, 2009). This interference with transparency can harm shareholders' interests by enabling opportunistic managers to divert resources for personal gain, leading to conflicts between management and shareholders.

Tax avoidance exploits legal loopholes to create tax savings (tax shields). In contrast, tax evasion involves illegal attempts to evade taxes, such as failing to report taxable income. While tax evasion is considered a violation of law, avoidance operates within the legal framework, exploiting weaknesses in tax legislation. Consequently, courts and tax authorities cannot invalidate tax avoidance activities, as they are legitimate transactions, even if conducted with the intent of minimizing tax liabilities [29, 31, 32].

Prior to the 2015 amendment to Iran's tax laws, tax evasion was not criminalized. Research highlights several common factors underlying tax avoidance and evasion in Iran, including:

1. Insufficient promotion of tax culture and public attitudes toward the tax system.

2. Incomplete reporting of economic activities.
3. Delays in tax collection and payment.
4. Late identification or lack of documentation of taxpayers' income.
5. Extensive tax exemptions under supportive or incentive policies.

6. Tax Auditing

An analysis of the structure of the Direct Tax Code (specifically regarding Iranian companies) and the factors influencing taxable income raises several key issues. Tax auditing involves examining a measurable claim against predetermined criteria by an independent examiner, who then reports the findings. Thus, financial statement auditing entails expressing an opinion on their conformity with accounting standards by an independent auditor, based on auditing standards, which govern the quality control of this process [33].

In tax auditing, the claim refers to the tax return, and the criterion used for evaluation and comparison is the Direct Tax Code. However, the outcome of the audit is expressed as a tax assessment rather than an opinion, differentiating it from financial auditing. Furthermore, tax auditing is not governed by auditing standards or attestation service standards because it does not validate or certify the claim. Instead, it determines taxable income, validating the reported profits. In contrast, financial auditing does not validate profits but provides an opinion on the overall financial statements. Therefore, tax auditing cannot be classified as compliance auditing since its primary purpose is not solely to assess whether taxpayers have adhered to tax laws and regulations.

When examining factors influencing taxable income in Iranian companies, tax laws—serving as a strategic framework for fiscal policy—are commonly divided into two categories: direct and indirect taxes. The former applies directly to wealth and income accrued to individuals, while the latter primarily encompasses the Consolidation of Duties Law and the Value-Added Tax (VAT) Law.

The key factors influencing the taxable income of legal entities, as outlined in the Direct Tax Code, include:

1. Permanently tax-exempt income.
2. Temporarily tax-exempt income.
3. Income subject to a flat tax rate lower than the corporate income tax rate.
4. Income subject to the corporate income tax rate.
5. Allowable expenses explicitly defined in tax laws.

According to this categorization, generating income from higher-ranked categories results in lower taxes because no taxes are paid on such income either in the present or the future. Conversely, if an expense is deemed acceptable under accounting standards but is not explicitly addressed in tax laws, it will not be considered allowable by the tax auditor [3, 18].

To clarify how these factors interact, consider the scenario where all of a company's income falls into categories exempt from tax or subject to flat rates (categories 1, 2, 3). In this case, the company's cost structure and utilization of other exemptions do not affect the final payable tax. However, if all income is subject to the corporate income tax rate (category 4), the cost structure and utilization of exemptions have a maximal impact on the final payable tax.

Therefore, the final taxable income and the company's effective tax rate are directly related to the type of income, cost structure, and extent of exemptions utilized.

7. Measures to Improve Tax Compliance

The primary goal of tax authorities is to collect payable taxes while maintaining public trust and confidence in the tax system and organization. Taxpayer behaviors, such as negligence, carelessness, or deliberate evasion, combined with weaknesses in tax administrations, make breaches in compliance with tax laws inevitable [18, 19]. Therefore, continuous and sustainable improvement in tax compliance must be achieved through the application of appropriate tools.

According to Roth et al. (1989), taxpayers and tax authorities adopt different positions on compliance when laws are ambiguous. Ambiguity in tax laws poses a significant problem for taxpayers across all income levels. Additionally, studies by the National Tax Administration (2018) highlight that part of compliance improvement involves identifying related risks. Risks can be analyzed at various levels but are broadly categorized into strategic and operational-tactical levels, or a combination of both [20].

Strategic risks typically require comprehensive actions, including reforms in tax laws, regulations, and processes, while operational risks necessitate routine actions. At the strategic level (a top-down approach), the main objective is identifying specific non-compliance behaviors that, if left unaddressed, would reduce tax revenues. Reviewing tax laws is the most effective way to assess strategic risks, and tax experts are well-positioned to identify legal risks [13, 17].

Identified strategic risks can then be examined further, such as by market sectors or organizational capacities. Due to the prescriptive nature of tax laws, anticipating all potential scenarios arising from the application of these laws is challenging, making it nearly impossible to draft entirely clear and unambiguous legislation. This ambiguity creates opportunities for non-compliance. Using a common framework for managing strategic risks can assist senior management in evaluating the entire spectrum of risks. One such framework is the compliance risk matrix, organized according to taxpayer obligations. In some cases, project-based strategies are employed instead, addressing risks related to transfer pricing, aggressive planning, the shadow economy, VAT refund fraud, and more. However, relying solely on project-based structures or organizational frameworks for risk identification is risky, as it may fail to capture the full range of strategic risks and limit senior management's involvement due to insufficient knowledge [8, 16, 26].

Additionally, neglecting certain issues at this stage may compromise the long-term efficiency and sustainability of tax collection. Public trust in the fairness of the tax system significantly impacts future revenue stability. Another important principle to consider is the distinction between high-risk activities and high-risk actors. Some activities inherently carry greater risks than others, and the same applies to taxpayers, whose compliance levels can vary significantly. Recognizing these distinctions is crucial when identifying risks. An overview of risks at the beginning of the process can provide managers with insights into the scope and significance of the issues, without delving into excessive detail.

8. Operational Risks

Identifying compliance risks at the taxpayer level is essential. This level, which can extend to individual tax files, aims to pinpoint cases involving taxpayers contributing to strategic-level risks. At the operational level (case-based approach), selected taxpayers' characteristics and account activities are reviewed, enabling an impartial evaluation of their risks relative to others. Some file-based systems even estimate the tax amount at risk [30].

In risk management, identifying strategic risks should precede operational or case-based risks. Strategic risk identification lays the groundwork for recognizing operational risks. However, strategic risk analysis is influenced by the continuous collection of data, which gradually transforms into information and knowledge. Compliance risks can be analyzed from various perspectives. Although typically assessed from the perspective of individual taxpayers, they can also be examined from industrial, socio-economic, or psychological viewpoints. Given the diverse taxpayer population, segmenting taxpayers into homogeneous groups based on shared characteristics is common. This "market segmentation" approach involves dividing customers into subgroups with similar traits to better understand their behaviors and needs, identify risks, and propose solutions to improve compliance. In tax systems, common classifications often include small, medium, and large enterprises based on criteria such as turnover, gross income, or other characteristics. Other classifications might be based on industry type (e.g., agriculture, professional services, commerce), tax type (e.g., direct, indirect), or risk type (e.g., domestic, international, tax avoidance).

9. Levels of Operational Risk Management

1. **Tax Resource Level**: Risks are identified and managed based on tax resource types, such as corporate taxes, business taxes, VAT, inheritance taxes, etc. However, this approach is rarely utilized in practice.
2. **Industry or Sector Level**: Taxpayers are classified based on shared attributes like legal form, size, turnover, number of employees, industry type, significance, compliance level, or a combination of these factors. Compliance levels are then estimated using specific criteria to identify risks associated with taxpayer obligations.
3. **Taxpayer or Case Level**: Compliance risk identification is confined to individual taxpayers or cases. Various indicators are used to evaluate compliance levels. This level employs systematic and model-based risk management, using data from tax returns, taxpayer histories, observed behaviors, and information from other sources to assess compliance [16].

According to the OECD risk identification model (2004), higher levels of risk management necessitate a proportional increase in knowledge. This model emphasizes two key activities:

1. Advanced tools become essential as strategic information increases.
2. Progress from data to knowledge involves extracting patterns and trends from data, which enhances understanding and adds value to insights into future developments [16].

Examining tax laws and regulations at the market level (macro and strategic risks) and consulting with experts can identify tax risks and inform systematic responses. Strategies at this level include mitigating risks, strengthening deterrence, enhancing tax administration capabilities, detecting risks, addressing violations, and closing legal and procedural loopholes [20].

At a lower level, risks can be examined in broader groups, such as tax resource types, major sectors, industries, and taxpayer groups. Responses at this level often include leveraging strategies, awareness campaigns, negotiation, education, and enforcement [20].

Finally, at the taxpayer or case level, risk identification primarily relies on existing data about taxpayer performance and history, utilizing scientific techniques and computerized systems. Strategies at this level focus on enforcing legal provisions proportionate to detected violations [20].

Regarding non-compliance, the frequency (instances and tendencies for non-compliance), severity (likelihood of occurrence), and consequences (monetary cost of non-compliance) are key considerations. Studies highlight that revising laws for clarity, reducing exemptions, and ensuring accurate taxpayer reporting through stricter enforcement mechanisms can significantly improve compliance [3, 17, 20, 33].

10. Conclusion

Under the law, penalties are imposed for illegal non-compliance (tax evasion) upon detection, whereas commercial activities motivated by legal non-compliance (tax avoidance) cannot be invalidated by judicial authorities or the tax administration. This is because no restrictive laws exist to prevent tax avoidance, and the transactions involved are legitimate, even if conducted for the purpose of tax avoidance. Therefore, while legal limitations on tax avoidance have not been established, tax evasion has been criminalized, a provision that was introduced only after the 2015 amendment to the Tax Code.

To reduce tax evasion, enforcement mechanisms have been expanded. Additionally, the requirement for economic actors to disclose transaction and interaction data has improved access to comprehensive economic information, enhancing the tax administration's database. This has contributed to reducing tax evasion and broadening the tax base. However, tax avoidance remains largely unaffected under the current legal framework.

Overall, steps have been taken to reform the structure of the Direct Tax Code to reduce conflicts between the National Tax Administration and taxpayers. Strengthening economic information systems for taxpayers has been a key measure to maximize compliance.

Authors' Contributions

Authors equally contributed to this article.

Ethical Considerations

All procedures performed in this study were under the ethical standards.

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Conflict of Interest

The authors report no conflict of interest.

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