MANAGING TAX AUDIT AND INVESTIGATION: STRATEGIES FOR EFFECTIVENESS

BEING A PAPER PRESENTED AT A MANDATORY PROFESSIONAL TRAINING PROGRAMME

ORGANISED BY THE CHARTERED INSTITUTE OF TAXATION OF NIGERIA

AT BRIDGE WATERS HOTEL & CONFERENCE CENTRE, ENUGU,

ON WEDNESDAY MARCH 7, 2018

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INTRODUCTION

The primary goal of a revenue body’s compliance activity is to improve overall compliance with their tax laws, and in the process instil confidence in the community that the tax system and its administration are fair. Instances of failure to comply with the law are inevitable whether due to taxpayers’ ignorance, carelessness, recklessness and deliberate evasion, or weaknesses in administration. To the extent that such failures occur, governments, and in turn the communities they represent, are denied the tax revenues they need to provide services to citizens. Historically, most taxpayer-driven failures or compliance risks have been addressed nearly exclusively in terms of regulatory enforcement through an audit-based approach. In more recent times, revenue administrators have come to realise that the factors underlying taxpayers’ compliance behaviour in any specific risk area are varied and often complex, and are unlikely to be treated successfully with a ‘single action’ strategy, particularly one based exclusively on regulatory enforcement action such as audits. This particular development is dealt with in considerable detail in the accompanying guidance note ‘Managing and Improving Tax Compliance’ published in late 2004.

Nevertheless, audits remain a major tool for tackling non-compliance and in revenue bodies in most OECD countries constitute the largest deployment of resources for administration of the laws.

The current focus on non-oil revenue has placed more demand on tax authorities in Nigeria to increase tax revenue. The tax authorities have identified audit/investigation, among others, as the vehicle to achieve their revenue budget. This has therefore resulted in increase in the number of tax audit/investigation in recent times.

Tax audit/investigation can be very challenging for taxpayers, as mismanagement of the process can lead to prolonged reconciliation meetings and increased tax liabilities. Therefore, proactive management of the exercise is very important.

The frequency of tax audits and investigations, in recent times, by the Federal Inland Revenue Service (FIRS) and the various State Boards of Internal Revenue (SBIR) has been on the increase. This could be attributed to the efforts of the government to diversify its revenue from oil revenue to non-oil revenue sources, of which taxation forms a major part. The Federal Government of Nigeria currently has projected to increase its non-oil revenues over the coming years as highlighted in the 2017 to 2019 Medium Term Expenditure Framework. For example, non-oil revenue in the 2017 budget is projected at ₦2.95trillion. This represents about 60% of the budgeted revenue of ₦4.94trillion for 2017. It is expected that the expansionary government spending programme from 2017 onwards would drive growth in the non-oil sector and, ultimately, profitability and tax base of companies in the face of current economic challenges. As a result of the ambitious non-oil revenue target, the relevant tax authorities (RTAs) have intensified efforts to meet their set targets. Achieving the targets would require broadening the scope of tax coverage and driving continued compliance by taxpayers through timely tax
audits and investigations. This article is intended to deepen taxpayers’ understanding of tax audit and investigation processes, and provide insights on how to effectively manage expectations. **OBJECTIVES**

By the end of this presentation the participants should be able to understand and explain salient issues regarding tax audit programmes, conduct of audits and emerging tax issues including:

- What is tax audit and the role of tax audit activities.
- Tax Audit Scope and Intensity.
- Tax Audit techniques and support tools.
- Why increase in KRA Tax Audits.
- KRA Lifestyle audits of tax payers and Tax Officials.
- KRA Tax audit improvement and governance framework.
- Emerging tax issues Definition

**WHAT IS A TAX AUDIT?**

A tax audit, or a MIRA audit, is simply an examination of your accounts and financial affairs to verify that you have declared the correct amount of tax.

A tax audit is an examination of whether a taxpayer has correctly assessed and reported their tax liability and fulfilled other obligations. Tax audits are often more detailed and extensive than other types of examination, such as general desk checks, compliance visits/ reviews or document matching programmes. There are, of course, exceptions to this rule. Conditions and approaches vary from country to country. Generally, an audit will examine the issues seen as most significant to achieving an accurate assessment of a taxpayer’s tax liability. Typically, these issues will include any indications of significant unreported income (for example, as may be suggested by a very low ratio of net/gross business income ratio computed from a taxpayer’s return) or potentially over-claimed deduction items that may be apparent from an examination of a taxpayer’s tax return and other information. As well as income tax returns and other reporting, this includes supporting documents, which the taxpayer should normally have. In the case of business audits, national law often requires a business to obey certain bookkeeping and accounting standards. The audit may also involve physical
enquiries, such as the inspection and examination of goods in stock, premises etc. 19. Audit periods, frequency and coverage differ from country to country.

Tax Audit vs Tax Investigation

IRAS tax investigation is usually carried out on a taxpayer who is suspected of tax evasion. The aim of the tax investigation is to gather sufficient evidence on the tax evasion scheme and then prosecute the tax evaders in court to send a strong deterrent message to the public. In order to preserve the documentary evidence for prosecution, a surprise visit is necessary for tax investigation cases.

On the other hand, IRAS tax audit is an inspection of the tax filing with an objective of rectifying errors and educating taxpayers. A taxpayer usually receives an advanced notification from the IRAS tax auditor prior to the auditor’s visit. Such visit by auditor is called a field audit. IRAS audit can also be in the form of desk audit where query letters are sent and the tax payer is required to bring the necessary documents to the IRAS for inspection. Tax Audit Process is less complicated than the Tax Investigation Process.

Tax audit and investigation in Nigeria

Tax audit entails a review of taxpayer’s records to ascertain compliance with the relevant provisions of the Nigeria tax laws. This review is usually carried out within a 6 year period from the date of submission of the relevant returns. However, where the tax authority suspects fraud, neglect or wilful default, an investigation may be conducted without any time limit. Tax audit and investigation should be an area of great concern to taxpayers, since if it is not properly managed, the outcome of the exercise could have a negative impact on their reputation and operations. This is in terms of the penalty and interest that the RTA may impose on additional tax liabilities (except companies income tax and education tax) established by the audit. Prior to the introduction of the self-assessment scheme, there was no specific provision in Companies Income Tax (CIT) Act for tax audit and tax investigation. However, the CIT Act, based on subsequent amendment, empowers the FIRS to carry out tax audit or investigation of tax payers’ books of accounts and records. Thus, under the self-assessment tax filing regime, the RTA would need to periodically review and verify the tax returns submitted by taxpayers by way of an audit and / or investigation. The exercise essentially is meant to enable the RTA satisfy itself that the relevant returns submitted by the taxpayer agree with the underlying records and are sufficient for the purpose of determining the taxable profits of the taxpayer and, consequently, the tax payable. The selection criteria for tax audit and/or investigation are determined by the appropriate RTA. Based on experience, we have outlined some approach that could be adopted by the RTA in determining the taxpayer’s records to review: 1. Holistic Approach: Under this option, taxpayers are selected for a review periodically. The review is to
enable the RTA confirm the appropriateness of selfassessed returns. The exercise is typically carried out annually or biennially etc., and it is solely at the discretion of the RTA to determine the frequency. 2. Target Approach: Under this option, the taxpayer’s records may be reviewed based on leads from intelligence gathered internally or from external sources. The RTA would typically focus on the suspicious areas during this review.

Types of Tax Audit

Desk Audit: This is an audit where the MIRA requests for information to verify an amount in your tax return, but does not visit your premises or perform substantive audit procedures.

Field Audit: This is the most common type of audit conducted by the MIRA. After notifying you that you have been selected for an audit, the MIRA auditors will visit your premises to inspect and examine your business and financial records. Upon conclusion of the audit, the MIRA will issue a report on the findings of the audit (“Audit Report”) and a Notice of Tax Assessment (“NOTA”).

Audit scope and intensity:

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

• Full audits – The scope of a full audit is all-encompassing. It typically entails a comprehensive examination of all information relevant to the calculation of a taxpayer’s tax liability for a given period. The objective is to determine the correct tax liability for a tax return as a whole. In some countries full audits are carried out as part of random audit programs that are used to gather data on the extent, nature and specific features of tax compliance risks, for compliance research purposes and/or the development of computerised audit selection formulae. Given their broad scope, full audits are typically costly to undertake—a substantial program of full audits will require considerable resources and reduce the rate coverage of taxpayers that could otherwise be achieved by a more varied mix of audit types.

• Limited scope audits – Limited scope audits are confined to specific issues on the tax return and/or a particular tax scheme arrangement employed by the taxpayer. The objective is to examine key potential risk areas of noncompliance. These audits consume relatively fewer resources than full audits and allow for an increased coverage of the taxpayer population.
• Single issue audits – Single issue audits are confined to one item of potential non-compliance that may be apparent from examination of a taxpayer’s return. Given their narrow scope, single issue audits typically take less time to perform and can be used to review large numbers of taxpayers involved in similar schemes to conceal non-compliance.

WHY ARE YOU SELECTED FOR AN AUDIT?

The MIRA does not usually disclose how and why taxpayers are selected for audit. However, if you are being audited by the MIRA, chances are that you have been selected for one of the following reasons, as listed in the MIRA’s Audit Guide.

1. Random selection.
2. You have a higher risk compared to others (risk is usually assessed through certain criteria set out by the MIRA).
3. The MIRA’s compliance team has observed an issue that needs to be further checked.
4. The MIRA’s compliance focus includes the business activity you are involved in.
5. You have requested for a refund.
6. You are a large taxpayer subject to continuous risk reviews.

Preparing for the tax Audit exercise.

A tax audit isn’t a time to panic, it’s a time to prepare. Many small businesses are asked to supply back-up documentation to support deductions and business expenses, and if you keep good company records, a tax audit can be converted into a simple inconvenience.

The key is to prepare for your meeting with the tax auditor. It may be a local auditor, a state auditor, or a federal tax auditor from the IRS. Whatever the case, you want to be prepared with good information and documentation that supports the tax filing under scrutiny.

Here are some tips on how to help avoid trouble when faced with a business tax audit.
**Ask For An Extension.** Postpone your meeting with the auditor for as long as possible. Ask for an extension to gather together your records and other information required to demonstrate to the auditor that your business reported all income and that you are, indeed, entitled to any deductions, credits or exemptions claimed.

**Know what the IRS or other auditing agency wants.** Anything from the IRS can be unnerving, so read the audit request once more. Have legal counsel read it if you’re confused about what the auditing agency really wants. In many cases, that letter from the IRS is simply requesting additional information. Don’t panic. Prepare.

Of the people and businesses who are audited, 75% of them face a correspondence audit, meaning you can mail copies of supporting documents. Make sure to send copies and keep the originals.

**Go to the auditing agency’s office. Don’t have coffee and donuts in your place of business.** If the auditor is coming to your office, you’re facing a field audit. If possible, ask that any discussions take place at the government agency’s office. If you are facing a field audit, delay it and hire a tax professional to help get your documents in order.

**If they don’t ask, you don’t answer.** If you have a tax professional or tax lawyer representing you, have him or her answer the auditor’s questions. NEVER offer information. If they don’t ask, don’t volunteer information. Say as little as possible during the audit without looking like you’re hiding something.

**Get your paperwork in order.** You may choose to hire an outside consultant to locate and organize your audit file. Provide only that information that the taxing agency asks for. Once again, if they don’t ask for it, don’t mail it in just to show how honest you are.

**Know your rights under the law.** For example, in most cases, your business has 30 days to respond to an audit letter. You’re entitled to representation. You can ask for an extension – even if the audit is just a day or two away. Be sure to read (and understand) IRS Publication 1 titled *Your Rights As A Taxpayer.*

If you’re being audited by a state or local agency, ask for a copy of audit guidelines and a booklet explaining your rights. Don’t allow your business to be bullied. You do have rights under law. Know your rights. Exercise them to your company’s advantage.

**If you don’t like the results, you have the right to appeal.** You can appeal the auditor’s decision if it doesn’t seem fair or just. There’s a standardized process for developing an audit report.
Contact the auditor if you’re confused about the examination report. Meet with the auditor’s supervisor. Keep kicking the case up the ladder until you get answers. If answers aren’t forthcoming, you may have to take the auditing agency to tax court – something to avoid at all costs because it’s a big cost for representation by a tax attorney.

An audit isn’t a reason to panic, but you should have your paperwork in order, back-up information from the company CFO or CPA, and if needed, get help from a tax lawyer.

Pay your fair share, but don’t be pushed around. Get help for an audit.

Get help for your business.

**Documentations required**

Managing Tax Audits

**HOW WILL AN AUDIT AFFECT YOU?**

Conducting tax audits is one of the key functions of the MIRA. If the MIRA finds that your tax liabilities are not computed or declared in accordance with the law, the MIRA will make an assessment of the amount of tax that you are required to pay. This means that you may end up having to pay additional tax assessed, fines and penalties for short payments. In such cases, fines are applied from the original due date of those taxes.

The best approach in response to an audit will be to prepare thoroughly for it, and at the same time, being aware of your rights and obligations in such circumstances.

**THE AUDIT PROCESS**

Neither the Tax Administration Act, nor the Regulation provides a detailed explanation of the actual audit process. However, the MIRA has issued various publications that provide some detail on the stages of an audit. The basic framework is listed below:

**Conditions Precedent to Audit**
. Notification of the audit

If you are selected for a tax audit, the MIRA will notify you in writing. You or your representative may also get a call informing you about the audit. The written notification you receive is known as the “Audit Notice” and it will indicate the expected commencement date of the audit, period covered under the audit, and the documents that may generally be examined during the audit. At this point, you may discuss with the MIRA and decide on a time that the audit may take place, your contact point and the principal place where the MIRAs auditors may conduct audit work.

2. The first meeting

Prior to commencing the audit, the auditors assigned by the MIRA to conduct your audit will generally conduct an interview with you or your representative. This meeting is focused on understanding your business, your record keeping process, the scale of operation, and other information that may be necessary to start the audit.

Managing Tax Audits

Tax Payers Perspectives.

. Field work

After the first meeting or interview, the MIRA auditors start the audit by reviewing your business records. Often, this involves observation and examination of your business procedures, processes, internal controls and documents. If the MIRA auditors require any additional documents, they will request that you provide them. Usually, such requests may be made informally (verbal or email), but in some instances, they may issue a formal Document Request Notice (“DRN”) specifying certain documents that they require.
In case the MIRA sends a DRN to you, you have 30 days to produce the documents indicated in the notice. If you have reason to believe that the documents are not relevant to the audit, you have the right to appeal that notice to the Tax Appeal Tribunal ("TAT"). Unlike other appeals to the TAT, you need not file an objection to the MIRA before filing the appeal to the TAT.

4. Communication of audit findings

Upon completion of the audit procedures, the MIRA will usually contact you to discuss the findings of the audit and the amount of tax and fines assessed. If you disagree with any of the points raised in the draft assessment, you should discuss the matter with the auditor and formally raise your concerns in writing.

5. The final report

After you comment on the draft Audit Report, the MIRA will issue a final Audit Report. This report will point out the audit findings, and will be issued with a NOTA that shows any additional taxes that you need to pay. If the audit is for a period for which you have filed a tax return, the MIRA’s assessment will also include adjustments that have been made to your tax returns.

6. Settling payment

If the MIRA makes an assessment of an additional amount of tax, you have 30 days from the date of the NOTA to make the payment. If the outstanding payment is not settled within 30 days, the MIRA will commence with enforcement actions as per the Enforcement policy of the MIRA.

It is advised that you settle the payment of additional tax as early as possible as fines keep on accruing from their original due date up to the date of payment regardless of what date that may be. If you are unable to make the payment in its totality, you may submit a request with
the MIRA to allow you to make the payment by way of an instalment agreement with the MIRA. The MIRA has the discretion to reject instalment payment requests.

You must take note that even if you are allowed to pay under an installment agreement, fines will keep accruing until the outstanding amount is fully settled.

Managing Tax Audits

7. Resolving disputes

If you disagree with the final Audit Report and you think that the MIRA’s assessment of tax does not truly reflect your tax liabilities, you can formally object to the MIRA in writing. Your objection must be filed within 30 days of the Notice of Tax Assessment and must be lodged using a MIRA 903 form.

You are not obliged to settle the outstanding amount of tax and fines at this point. However, fines accruing from non payment of additional tax assessed by the MIRA will keep on accruing until you settle the outstanding amount.

It is advised that you seek assistance of a tax advisor when you file an objection as it is important to strategically raise your grounds for objection. These grounds will be the basis for an appeal with the TAT in case the MIRA disallows your objection.

8. Appeal to the TAT

Once you file an objection, the MIRA will review your objection and issue an “Objection Review Report”. If the MIRA has disallowed your objection, you may lodge an appeal with the Tax Appeal Tribunal. You must settle all outstanding taxes and fees before filing an appeal even if those outstanding payments do not relate to the amounts stemming from the disputed matter. It is advised that you appoint a professional tax advisor or a legal counsel who can
represent you at the Tax Appeal Tribunal.

**Tax Authority Perspectives**

A comprehensive legal framework, including an appropriate regime of sanctions.

- Well-defined organizational and management processes, including a comprehensive performance measurement framework.
- Well-defined audit techniques and adequate support arrangements; and.
- Adequate human resource management and development programs

**AUDIT EXAMINATION TECHNIQUES**

Analytical review - An analytical review of financial statements and returns as filed is often completed during the preliminary stages of the audit. Investigative approach - Such an approach uses information obtained through observation, discussion, documents or records obtained from either the taxpayer/registrant or from other sources. Records Examination - the main approaches to detect false accounting include the examination of books and documents conducted at the taxpayer’s business office or branches, counterpart examinations and examination of bank accounts. Third party information/Counterpart examinations - Where warranted, information can be obtained during the course of an audit from third parties to verify the taxpayer’s income,

**Conditions that trigger Tax Audit and Investigations**

Trigger Points and Management Strategies Notwithstanding the above approaches, certain identifiable items are primary triggers for a tax audit or investigation: i. High operating expenses ratio to revenue: The RTA could typically conduct a ratio analysis of some items in the financial statements, with a view to ascertaining compliance with predetermined parameters. A high operating expenses ratio to revenue is a trigger, as the RTA would seek to scrutinize the components of the expenses and confirm if they meet the tax deductibility test. Relevant information on the expenses would be required e.g., documentary support for the cost, the entity to which the cost relates, whether the costs were incurred by, or on behalf of a related party, compliance with the arm’s length rule etc. Maintaining proper documentation and records is key to managing potential exposure that could result from a review under this trigger. ii. Deductibility of cost – Financial vs Tax: While the relevant Accounting Standards determine the basis on which expenses can be accrued and treated in the records of companies, the tax laws provide for the basis of their deductibility. The CIT Act, for example, allows only costs that are “wholly”, “reasonably”, “exclusively” and “necessarily” (WREN) incurred in the production of profits as tax deductible. While
some costs are specifically not allowed by the CIT Act, e.g., donations (other than donations made to bodies listed in the 5th Schedule to the CITA), general bad debt provisions, etc., other costs are required to satisfy the WREN test to be tax deductible. Taxpayers should ensure that, in addition to reporting financial transactions in line with the relevant accounting standards, their costs are reviewed for compliance with the provisions of the tax laws to determine their deductibility. iii. Significant fluctuations in assessable profits: Where there is a significant increase or decrease in the taxpayer’s assessable or total profits, the RTA may be put on inquiry with a view to conducting an audit or investigation. In this case, proper clarification supported by adequate documentation will assist in resolving any concern raised. iv. Significant value added tax (VAT) and withholding tax (WHT) receivable: Most companies have challenges obtaining their WHT credit notes from customers. This creates a massive WHT receivable in the taxpayers’ books and in turn attracts the attention of the RTA to scrutinize their records. The scrutiny will assist the RTA to ascertain the rationale for nonutilization of the WHT credits. From experience, it may be more efficient for a company with significant WHT receivables to outsource the tracking and collection of their WHT credit notes to a tax consultants unless it is willing to dedicated resources internally for the exercise. Furthermore, companies that provide services to oil and gas companies and government agencies face a peculiar situation where there is an enormous unutilized allowable input VAT. This is as a result of the amendment to the VAT Act in 2007 which requires oil and gas companies and government agencies to deduct VAT at source in respect of payments made to contractors. In this case, the taxpayer will not have output VAT from this source against which to offset its allowable input VAT. Its default option in the circumstances will be to claim a refund from the FIRS. Based on the provisions of the FIRS (Establishment) Act, the RTA will audit or investigate the taxpayer’s records to establish the validity of any claim for refund. Such companies are advised to maintain relevant records, such as purchase invoices, import documents etc., for the purpose of claiming the VAT refund. v. Business restructuring: A taxpayer may restructure business operation as a growth strategy or to better manage its operations. However, the RTA may be put on inquiry and seek to re-evaluate such restructuring through a tax audit or investigation to forestall tax avoidance by the taxpayer. vi. Transfer pricing (TP) arrangements: A taxpayer conducting significant transactions with related parties is susceptible to review. The RTA would seek to confirm that the related party transactions are conducted at arm’s length and that there is no tax avoidance scheme (such as by way of base erosion and profit shifting, etc.), in such arrangements. Maintaining proper transfer pricing documentation in the form of TP policies, TP benchmark studies, TP © 2017 KPMG Advisory Services, a partnership registered in Nigeria, and a member of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a swiss entity. All rights reserved. disclosure and declaration etc. would go a long way to address any concern in this regard. Other key triggers which may attract the attention of the RTAs include situations where a taxpayer engages in aggressive tax planning, or have significant unutilized capital allowance, inconsistency in filing of tax returns, frequency of acquisition and disposal of qualifying capital expenditure, mergers and acquisition, claims under Double Taxation Agreement etc. Although tax audit or investigation could be daunting, adequate preparation and a well thought-out approach could assist to mitigate its burden. For instance, the taxpayer may decide to keep its records in electronic form for ease of retrieval during future tax audit or investigation, and or appoint a tax consultant for professional support. Furthermore, on completion of a tax audit exercise and issuance of the appropriate report by the RTA, adequate
preparation and availability of supporting documents would enable the taxpayer address the issues raised in the tax audit and investigation reports and during the reconciliation process. The importance of this cannot be over-emphasized, as it is key to ensuring timely closure of tax audits and investigations.

ROLE OF TAX PAYER AUDIT PROGRAMMES

□ Promote voluntary compliance: The primary role of the audit program is to promote voluntary compliance by taxpayers with the tax laws.

□ Detect non-compliance at the individual taxpayer level: By concentrating on major areas of risk (e.g. unreported cash income) and those individual taxpayers most likely to be evading their responsibilities, audits may bring to light significant understatements of tax liabilities, and additional tax revenue collections.

□ Gather information on the “health” of the tax system (including patterns of taxpayers’ compliance behaviour): Audits conducted on a random basis can assist overall revenue administration by gathering critical information required to form judgments on overall levels of tax compliance. ‘

5 ROLE OF TAX PAYER AUDIT PROGRAMMES...CONT □ Gather intelligence: Audits may bring to light information on evasion and avoidance schemes involving large numbers of taxpayers that can be used to mount major counter-abuse projects.

□ Educate taxpayers: Audits can assist clarify the application of the law for individual taxpayers and to identify improvements required to record-keeping and thus may contribute to improved compliance by taxpayers in the future.

□ Identify areas of the law that require clarification: Audits may bring to light areas of the tax law that are causing confusion and problems to large numbers of taxpayers and thus require further efforts by the revenue body to clarify the laws’ requirements and/or to better educate taxpayers on what they must do to comply into the future.

Conclusion

Tax audit or investigation is a continuous exercise that requires adequate planning and preparation. The process may, no doubt, result in extra cost to a taxpayer. However, a much higher tax exposure, including penalty and interest, could result from lack of adequate documentation and proper record keeping. Though rare, the outcome of a tax review may be an overpayment of tax by the taxpayer based on which it will be entitled to claim a tax refund. In conclusion, the relevant stakeholders including, but not limited to, the RTAs, taxpayers, tax consultants and practitioners should perform their respective responsibilities diligently and conscientiously for a fair outcome. The processes may be tedious, but the prospect of a seamless tax audit and inspection process is possible.