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Cross Check of the Tax Base in Serbia – Informative Tax Return Sample

Abstract: The tax system of the Republic of Serbia is characterized by a very low level of income taxation. It is a particularly acute problem in cross-checking the tax base. The legislature tried to solve this problem by the introduction of the informative tax return (IPP). The problem is even greater because the situations encountered have not been analysed in science and tax theory, and very often have not been covered by applicable laws. A specific challenge for the tax authorities represent taxpayers whose incomes are primarily realized abroad (usually persons from the world of entertainment). This paper describes the basic forms of tax offences characteristic of income tax evasion and discusses how to solve them, with a particular focus on the implementation of cross-checking the tax base.

Keywords: income tax, tax evasion, enforcement, tax authorities, informative tax return

JEL: H20, H24, H25, H26

Introduction

Tax policy is immanent to a state and results from its legal system. It is also a condition of material existence of the state and a stabilizing factor in the economy. The low level of tax collection in relation to potentially collectable tax, especially personal income tax, indicates the inefficiency of tax administration and a low level of tax culture of citizens. Implications of the increasing decline of liquidity transfer to the entire economy (Pejović & Dostić, 2015). We can often notice people with high incomes, usually untaxed, who convert those same in-

comes into extremely expensive real estate and other valuable mobile assets. The expanded coverage of taxpayers and those entities which have acquired enormous revenues with various illegal actions outside the tax system could make a significant contribution to efficiency of the tax policy in Serbia. Of course, this behaviour of citizens, which is reflected in the non-payment of personal income tax, continues in the form of non-payment of property taxes. In this way, the state remains deprived of a significant amount of tax revenue, and the citizens, as taxpayers, are richer at the expense of the state. Over the last few years, however, there has been a marked increase in concern with losses of VAT revenue through evasion and fraud (IMF WP, 2007). Unregistered tax payers who have intentionally or accidentally disconnected themselves from the tax system must be detected and included in the register of taxpayers.

Although personal income tax, and especially property taxes, represent less generous tax forms, with respect to taxes on consumption (VAT and excise duties), the attention of the tax authorities cannot remain outside the zone of interest of collection of these two tax forms. On the other hand, the tax collection system in Serbia has not been on a satisfactory level for many years. The inefficiency of the collection system is reflected both in personnel and in technical and technological terms, which will be discussed in more detail below. Spreading enforcement risk across multiple taxes may thus reduce the overall exposure of the fiscal system to revenue losses from evasion. (Keen & Smith, 2007).

In an attempt to improve tax collection, the legislator has stepped up its activities in order to provide more accurate and more comprehensive abstraction of citizens' incomes through the implementation of an information tax return. The meaning of the mentioned tax return is the possibility of the tax authorities to inspect a taxpayer's property which exceeds the value of 35 million dinars. In the next step, assets of the taxpayer as at 31 December of the current year would be compared to assets on 1 January of the current year, and if the taxpayer cannot prove the origin of the differences in assets, a personal income tax in the amount of 20 percent is to be charged.

1. Legal framework

At the very beginning, it is important to note that an information tax return does not determine the tax liability, but it is used as information to the tax authority about the amount of the taxpayer's property. So the informative tax return is only the first step, and a starting point for further determination of the tax base using the cross valuation method.

Normative acts which regulate the issues of Informative tax returns are the Law of Tax Procedure and Tax Administration and the Ordinance on informative tax return (the Ordinance), the latter as a bylaw. Changes related to various fiscal forms induce different effects on tax service development. (Pejović & Jovanović, 2013). The Law on Tax Procedure and Tax Administration defines the informative tax return as a report containing information relevant to the determination of tax liability of applicants. The data is considered, especially data on assets worth more than 35 million dinars, on status changes, business activities and financial transactions of the person who has submitted an informative tax return.

The Ordinance on informative tax return closely regulates the aforementioned problem, so it is prescribed that the information relevant to the determination of the tax liability of the applicant for informative tax returns is that which considers the asset of natural persons, whose total value in the country and abroad, on January 1st 2013, exceeds 35,000,000 dinars, and the assets of natural persons tied to the taxpayer, in tax terms.

Natural persons - taxpayers filing the application are considered:

1. payers of personal income tax in accordance with the law governing personal income tax, except for taxpayers who have only the citizenship of another country, and who are sent to work in the Republic of Serbia, or which are as addressed persons employed in the Republic of Serbia,
2. payers of property tax in accordance with the law governing property taxes.

Persons tied to the taxpayer filing the application are his/her family members, namely: the spouse, parents, children, adopted children and adoptive parents.

Assets involved in the tax base are considered:

1. real estate;
2. shares and stakes in the legal entity;
3. equipment for carrying out activities, the property of taxpayers filing the application, regardless of whether the taxpayer filing the application uses it for carrying out activities;
4. motor vehicles, boats and aircraft;
5. savings deposits and cash;
6. other property rights, as follows:
 - (1) real rights on real estate (usufruct, right of use or right of use “time-sharing“, the rights on long term lease, the right to use construction land);

- (2) copyright in the written part, dramatic, dramatic-musical, musical, and film work, work of art, computer programs and copyright related rights (rights of performers, producers of phonograms, producers of videograms, broadcast producer and producer of the database);
- (3) right to patent, trademark, model, sample, geographical indications and technical improvement;
- (4) the license;
- (5) right of ownership of other movable goods having in the value exceeding 550,000 dinars.

Real estate refers to all types of land, growing crops (orchards and vineyards), buildings, special parts of buildings, garages and garage places outside of buildings, sports facilities (stadiums, halls, swimming pools, etc.) and sports fields.

Total assets and their value are reported with balance as on January 1, 2013.

For the purposes of filing an information tax return, the taxpayer filing the application determines the value of the assets on the basis of prices that could be achieved in case of the sale of the assets on the market, on the day of January 1st, 2013.

Finally, the Ordinance provides that a taxpayer filing the application is required to submit an informative tax return for the period from January 15th to June 30th, 2013.

This method of determining the tax base is regulated by the Law on Tax Procedure and Tax Administration, which stipulates that the tax base is determined as the difference between the value of assets at the end and the beginning of the calendar year reduced by the amount of the reported income and the value of assets acquired by inheritance, gift or in any other legal unencumbered way, as well as the amount of revenue which is subject to personal income tax which is not included in the taxation of the annual personal income tax, which the taxpayer or another person points out (reports) and provides appropriate material evidence.

The value of assets at the beginning of the calendar year is the sum of total value of assets with balance as at 1 January of the calendar year.

The value of assets at the end of the calendar year is the sum of the total value of assets as at 31 December of the calendar year, increased by the value of property acquired with encumbrance in the calendar year, or disposed of with encumbrance or unencumbered, as well as for funds that the taxpayer used to purchase the property on behalf of third parties in the calendar year.

The tax base determined in such a manner represents unreported income, which is taxed as other income, in terms of the law which regulates personal income tax, without granting standard costs.

According to data from the Tax Administration of the Republic of Serbia, 3,773 tax returns were submitted. It is not so strong commitment as in developed countries. (Grubišić & Pejović, 2012).

In addition, during the control process, the Tax Administration revealed 439 persons who did not file a tax return, and the value of their assets exceeded 35 million dinars. The value of unreported property, determined in the control, amounted to 1,473,661,802.65 dinars. A request to initiate violation proceedings was submitted against 12 persons for not filing information tax returns and the imposed penalties amounted to 42,209,854.08 dinars.¹

As it can be seen, at this phase of tax procedure the Tax Administration is focused primarily on the determination of facts with regard to which taxpayer was obliged to submit a tax return, and failed to do so.

2. Determination of tax liability

At this point, we will first review the specific issues that arise from Information tax returns, which can significantly affect the amount of the tax base, and thus the height of the tax liability. Growth over the long term cannot be explained as simply the consequences of accumulation of aggregate factors (Bogetić, Pejović & Osorio-Roddarte, 2013). In technical terms, a proper establishing of the tax base and a precise definition of tax exemptions is required.

The main problem that occurs in filling the application is the data on the values of assets owned by the taxpayer. In countries with poorly developed institutions of the system and the economy in general, a big problem is the lack of asset markets, whether it is about real estate, equipment, securities, etc. In this regard, taxpayers are faced with an extremely thankless task of entering data about the “market” value of their assets themselves, while there is almost no market for any of the listed assets.

On the other hand, the Tax Administration often takes a very rigid attitude about the value of property, all in order to collect as much tax revenues as possible. For

¹ Ministry of Finance, Tax Administration, Central Office, Control Sector, Belgrade, May 2015.

example, in determining the tax liability to be charged, the Tax Administration considers higher prices of real estate than their market prices, as well as extremely ungrounded prices of used cars, as advised by the Automotive Association of Serbia, and the like.

Thus, there is an indisputable intention of the tax authority during the introduction and implementation of IPP, but it is necessary to perceive the problem from different angles, and make some corrections.

Certain aspects that significantly affect the issue of the IPP, and therefore the cross-check of the tax base are considered below.

2. a) Staffing aspect of the Tax Administration

The first problem that arises is insufficient staffing of the Tax Administration which administers the said tax form. Given the complexity of the matter, it can be clearly concluded that with an insufficient number of employees it is almost impossible to administer this specific tax form.

The second problem that has been identified is the existence of certain standpoints of the Tax Administration. It is particularly acute in part Ia / II Informative Tax Return - Information about shares, where tax administration takes an utterly erroneous stand about a company's equity. The attitude of the tax authority is that the value of shares in the amount of the founding capital registered with the Serbian Business Registers Agency should be entered in the relevant section. In doing so, two important aspects are completely ignored:

- 1) A company's equity represents the difference between assets and liabilities; in other words, in the company's equity, other items from the balance sheet must be entered in addition to the initial capital, as well as other capital, and therefore retained earnings. This is certainly gaining in importance if one bears in mind that limited liability companies are not obliged to distribute their profits after the adoption of financial statements at the companies' General Meetings.
- 2) Many companies have loss in their balance sheets that exceeds manifold the equity amount, so we have a situation that a certain business organization generally has no equity at all.

Now let us look at the example of a hypothetical balance sheet to see what kind of error the Tax Administration makes and how material it is, by neglecting the mentioned facts, with an assumption that a company is founded by one owner

who paid the legally prescribed amount for the establishment of the company of 500 euros. The exchange rate at 1:100, as shown in Table 1, will be applied for the purpose of this example.

Table 1: Hypothetical balance sheet with reported retained earnings

ASSETS		LIABILITIES	
Description	Amount	Description	Amount
1. Production hall	10,000,000	1. Equity	50,000
2. Equipment	2,000,000	2. Retained earnings	7,450,000
3. Receivables	500,000	3. Long-term liabilities	5,000,000
Total:	12,500,000	Total:	12,500,000

Thus, the owner of the given company has a value of equity of 7.5 million dinars, which is as per the assumed exchange rate 75,000 dinars, not 50,000 dinars or 500 euros as the tax authority claimed. If the owner of the company also has other assets in the amount of e.g. 280,000 euros, he will be required to file the IPP.

On the other hand, if we apply the wrong logic of the tax authority, the mentioned person will not be obliged to file the IPP because the total value of the assets is 280,500 euros. In this way, the tax authority overlooked a serious number of taxpayers whose assets exceed the amount of 350,000 euros.

Now, on the hypothetical balance sheet, we are going to analyse also the incorrectly taken position of the tax authority, which is a serious detriment to the taxpayer. This is a case where the company has shown a loss above capital, as shown in Table 2.

In this case, not only does the company owner not have any equity in the given company, and thus his shares are of no value, but the value of equity is negative in the amount of 1.5 million dinars, which implies that the elementary economic logic implies that bankruptcy should be declared.

Table 2: Hypothetical balance sheet with reported loss above capital

ASSETS		LIABILITIES	
Description	Amount	Description	Amount
1. Production hall	3,000,000	1. Equity	7,500,000
2. Equipment	500,000	2. Retained earnings	0
3. Receivables	0	3. Loss till capital	7,500,000
4. Loss above capital	1,500,000	4. Long-term liabilities	5,000,000
Total:	5,000,000	Total:	5,000,000

If we now apply this wrongly taken attitude of the tax authority, the company owner would have to fill in the amount of 7.5 million dinars under the rubric which refers to the value of shares, which is absolutely wrong, and thus his tax base has been increased without any foundation.

2. b) Technical - technological aspect

The Tax Administration has a need to exchange data with a large number of external systems, either to send data to these systems or to receive it from them. The Tax Administration has to grant tax incentives to support economy. (Fabris & Pejović, 2012) These systems are: the National Bank of Serbia, the Serbian Interior Ministry, Customs Administration, the Treasury, the Pension Fund, the Department of Statistics, the Business Registers Agency, the Central Securities Registry, the Republic Geodetic Institute - Real estate cadastre, and others. Although the information interconnection with state authorities is evident, the question is whether this networking is sufficient or whether it is necessary to interconnect the Tax Administration with a larger number of public institutions. In addition, a large problem is the quality of information that the Tax Administration receives in cooperation with the aforementioned state institutions. A large amount of incorrect data complicates the work of the Tax Administration, postpones tax control or leads to unnecessary controls.

These problems should be addressed from the perspective of the place, role and importance of the Tax Administration in the financial system of the country, especially if we keep in mind what position the tax authorities enjoy in most developed countries.

Namely, technical - technological equipment of the Tax Administration is particularly gaining in importance as a preventive measure against tax evasion, and in concrete case, the importance is reflected in those situations when taxpayers with significant assets have avoided submitting the IPP. For example, with adequate field control, as well as other measures and procedures, the Tax Administration in cooperation with the real estate cadastre can identify taxpayers who have avoided submitting the IPP, and in further work to identify and bill the avoided tax liability.

Now let us look at a hypothetical example to see what practical problems arise during the cross-check of the tax base, as well as the challenges which are posed to the tax authorities.

2.b.1) A case where a taxpayer has filed the IPP

According to the law, the tax authority should determine a possible difference in a taxpayer's property as at 1 January and as at 31 December, and if this difference exists, it is necessary to determine whether the taxpayer has reported assets acquired from legitimate revenues. Also, in accordance with the legal provisions, legitimate revenues are those revenues on which the corresponding taxes have been calculated and paid.

For the purposes of this example, we will assume that the taxpayer has reported the following assets:

1. Building total floor area of 300m², constructed in 2007,
2. Passenger car dated 2006,
3. Shares in the company XYZ doo Belgrade, 100% of shares, share capital 500 euros in dinars.

The first condition for accurate determination of possible tax liabilities, which the tax authorities face, is determining the realistic value of the property. This primarily means to determine the real value of movable and immovable property of a taxpayer, bearing in mind the underdeveloped assets market in Serbia.

In addition, as already mentioned, the treatment of capital is an extremely important item when determining the value of property of the taxpayer. In this regard, it is necessary to treat the value of equity as described earlier in this chapter.

The second condition represents establishing the source of the taxpayer's income. The paid-out amount of the taxpayer's income must be clearly defined from the tax return PPP PD. Special care must be taken of received income which is not included in the taxation of annual personal income tax, bearing in mind the legal provisions. This is especially important when one takes into account the frequency of errors in the determination of tax liability for the annual personal income tax.

Finally, a tax return for the annual personal income tax should be considered as a correction factor.

Assume the following:

- the difference in assets as at 01/01 and as at 31/12/2013 is 0.00 dinars,

- the taxpayer acquired assets during the period for which the statute of limitations and determination and collection of taxes of 5 years has already occurred,
- the taxpayer has no evidence that the assets were acquired from the income on which timely tax has been paid.

Adhering to the legal provisions, there was no increasing the value of assets for the period of submission of the IPP, and therefore there is no tax liability.

On the other hand, the taxpayer has no evidence of “legally” acquired property and there is no evidence that personal income tax has been paid, so the question is, whether this is the way in which taxpayers legalize illegally acquired property?

2.b.2) A case where a taxpayer has not filed the IPP

In this case, the situation is quite complicated, as with any other form of tax evasion. The tax authority has to face a challenge both from the aspect of personnel issues, and in terms of technical equipment.

The first possible direction in which the tax authority should act is to establish a database of taxpayers which will be linked to other government institutions, the Ministry of Interior, the Directorate for Prevention of Money Laundering, the Republic Geodetic Authority, Local Tax Administration, etc. On the basis of available data in the office control procedure, it is necessary to continuously carry out cross-checking of possible increase in taxpayer’s assets at the end of the year, with belonging revenues of the taxpayer. In this way, the situation of failure to file tax returns and tax evasion would be prevented. The other side of the coin is that jurisdictions with weak money laundering frameworks could be rated non-cooperative or high risk even if they do not have a severe problems with money laundering, but rather that they lack the resources to implement the framework recommended by FATF² (Marriage, 2013).

The second potential, and substantially more complicated, course of action is fieldwork. As a part of regular activities of the onsite control, targeted emergency examinations and collected information would help identify luxury assets of taxpayers. The next step would be to check the collected data via the information base, and if it is indeed the undeclared property, the next step would be the determination and collection of tax liability.

² The financial action task force (FATF)

Conclusion

Serbia, as other countries in the Balkans, is not a suitable environment for the assessment and collection of taxes and control of tax compliance. Because of that the tax personnel, especially those most qualified ones often leave their job. For these reasons, the Tax Administration is faced with constant hiring of new staff and their training for jobs that they are supposed to perform. The use of forensic accounting experts in tax litigation is an emerging field. (Muehlmann, Burnaby&Howe, 2012) Periods of transition and crisis are painful themselves, both in economic and social terms, and are accompanied by many irregular procedures of taxpayers. During such periods, people who have enough courage to get involved in business adventures appear as bearers of economic activity. Such people often cause great difficulty to the economic system due to the lack of expertise, knowledge of taxes and other regulations, and sometimes because of their mentality. Putting nonstandard and unusual behaviour of taxpayers in the foreground causes adjustment in the way that tax administration performs its activities. The problem is even greater because the situations that are encountered have not been analysed in science and tax theory, and very often have not been covered by applicable laws.

In an attempt to improve tax collection, the legislator has stepped up its activities in order to provide more accurate and more comprehensive overview of citizens' incomes through the implementation of the information tax return (IPP).

The issue of the IPP implementation, and thus the cross-check of the tax base, are influenced by many factors, and these stand out in particular:

- **Staffing aspect of the Tax Administration** - which is reflected in insufficient staffing of the Tax Administration, which administers the mentioned tax form. In addition, employed tax officials are exposed to various temptations, from threats to bribery. Apart from that, the tax authority has not had sufficient support in the political structures of power in recent years, which is another aggravating factor for its efficiency.
- **Technical - technological aspect** - which is reflected in the lack of informational interconnections with the Tax Administration and other state institutions. A separate issue is what kind of quality of information the Tax Administration receives in cooperation with other state institutions. If you enhance the exchange of information, adequate cross-check of possible increase of the taxpayer's assets at the end of the year with the belonging incomes would be carried out already within the office control. In this

way, preventive actions would be taken and avoidance of payment of tax liabilities would be prevented.

A specific challenge for the tax authorities represents taxpayers whose incomes are primarily realized abroad (usually persons from the world of entertainment). In this regard, the tax authorities must be specifically trained in the field of international treaties on avoidance of double taxation. It is particularly important that the aforementioned contracts are interpreted appropriately, and bearing in mind that the tax systems differ by the country, each country defines and treats a particular type of income differently.

In any case, when determining the tax base by the method of cross-checking, it is necessary to make a comprehensive review of taxpayers' income.

The most important request which is placed before tax authorities is the frequency of tax controls, bearing in mind the statute of limitations for determining and collecting taxes.

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