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# Does selecting a taxpayer for audit violate civil rights—a critical analysis of the Pakistani High Court’s decision?

Najeeb Memon<sup>1</sup> and Christian Lorenz<sup>2</sup>

## Abstract

This paper deals with taxpayers’ selection for tax audit under Self Assessment Scheme (SAS). Tax administrations across the world are continuously striving to improve the quality of taxpayer selection for audit, the one who gets selected asks why me? Recently, the Lahore High Court (LHC) in Pakistan has held that selection for audit by field officers, being discriminatory, violates the civil rights enshrined in the Constitution of Pakistan as equal protection under law for all citizens. This paper reviews international best practices and finds that tax agencies, through collaboration of central and field officers, use both objective and subjective criteria in the selection. Another finding is that tax agencies in various jurisdictions are given leverage to select any taxpayer for audit and the courts there do not hold such selections unconstitutional. A critical analysis of the LHC decision in this paper finds that it suffers from legal and rational fallacies because it has ignored the autonomy given by the superior courts of various jurisdictions for discriminating citizens in taxation if that has a reasonable basis and helps in securing tax objectives such as redistribution of income.

Keywords: Taxpayer audit, Selection quality, Civil rights, Self Assessment Scheme (SAS)

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legal jurisdiction to interfere in the internal distribution of work in tax administration  
Although the division of functions in an organisation is important to prevent  
concentration of authority in the hands



is of being caught, the less are the tax evasive practices.<sup>14</sup> Evading taxes is kind of gambling with the tax authorities. The risk or deterrence of being caught and losing money needs to be higher than the expected gain tax evasion. A study by the State Bank of Pakistan found that the lack of audits was responsible for poor tax collections in the years immediately after the introduction of the SAS in 2003. Further negative growth of collections on demand occurred after 2003 when audits ceased.<sup>15</sup>

Correct selection of audit subjects also optimises resource allocation of the tax administration because every taxpayer indiscriminately cannot be subjected to audit due to resource constraints.<sup>16</sup> Studies show that the greater the specificity in identifying the cases the less the number of selected cases.<sup>17</sup>

### 3. REVIEW OF PROCESS AND QUALITY OF SELECTION FOR AUDIT UNDER THE SAS

Although most tax regimes in developed economies have shifted to the SAS for





More broadly, strategic risk management is done in the central offices of tax administration whereas the local selection process is carried out by the field formations. When the central and field offices operate in synergy, synergy develops and the selection process produces better results. In practice, however, most selections are decentralized.<sup>36</sup> Some examples of developed tax jurisdictions follow so as to provide better understanding of the role of central and field offices of tax administration in selection of cases.

In the US, the Internal Revenue Service (IRS) and Discriminate Function (DF) which does macroeconomic statistical analysis operate together to observe cases for audit.<sup>37</sup> The US uses highly specialized Centralized Examination Classification Systems (CECS) for macro level analysis.<sup>38</sup> Beyond that, the review of selection by states of Florida and Columbia show that personal observations are predominantly used for selection.<sup>39</sup>

In Canada two tiers of tax administration are involved in the selection of cases: the central office performs a statistical analysis and then the experienced auditors examine that data and using local knowledge select cases for audit.<sup>40</sup> Local knowledge plays a decisive role in audit selection.<sup>41</sup> France and Japan also use collaboration between central and field offices for selection of cases.<sup>42</sup> In contrast the UK selection of cases for audit collectively or independently involves three tiers of tax administration.

New Zealand (NZ) has a Taxpayer Audit Selection System (TASS) whereby some cases are picked on the basis of selected queries. These cases are then exported to individual investigators to further scrutinize the returns. The investigators can also seek help from compliance risk officers (CROs) before selecting cases for audit.<sup>43</sup>

to pick the cases for audit in order to encourage taxpayers to comply with the tax code.

#### 4. SELECTION PROCESS UNDER THE PAKISTANI TAX CODE

In order to understand the evolution of selection of taxpayer's audit, the legal framework under the repealed ordinance Income Tax Ordinance 1979 and the new ordinance Income Tax Ordinance 2001 is visited in the following sections

##### 4.1 Repealed ordinance

Under s 59 of the repealed ordinance<sup>51</sup> non-corporate taxpayers were provided with self-assessment which was very liberal. The acknowledgment of filing of return was deemed as an assessment order. Only some cases were selected for audit by the central tax authority or its subordinate authorities by any method, which was prescribed by the central office. More simply, the method or scheme of selection was made part of the legal framework of the IAS. This shows that historically the selection, under the statute, was the domain of the central office with no or little role for the case managers.

##### 4.2 New ordinance

The legal framework under the rep2 (n)2 (d)MCID 5 >>Bhameewanreg(r)-2 ew the s6 onf r





requirement This indicates that the authority of selection for audit is completely constrained in Pakistan as both central office and case managers have to officially disclose any reasons.

Further, the reasons, which are









The court, however, has failed to explain how a civil or a criminal audit started with valid reasons by a statutory agency could cause interference with business and how a legal inquiry could obstruct a taxpayer carrying on their lawful business or profession. In this case the taxpayer will have been provided with all their rights during the audit process and no prejudice may be caused to them before or even after the conclusion of the audit. The taxpayer also has the right to appeal against the outcome of the audit before various appellate authorities from the Commissioner (Appeals) to the Supreme Court. Further, the court has also failed to appreciate that the SAS puts less

In its pronouncement the court also failed to take into account two important aspects. First, the Supreme Court of Pakistan has already stated that elements of discrimination in a fiscal statute cannot be pleaded nor can a statute be struck down on the basis of Article 25 of the Constitution. As a result, there are many examples where various incomes, persons and industrial sectors are taxed differently. For example, income from manufacturing is subject to tax in Pakistan while agricultural income is not. For effective taxation, superior courts in India have allowed varying tax regimes for different classes of persons based on reasonable and rational differentiation. The Supreme Court also mentioned that progressive taxation taxes citizens differently at varying levels of income for the sake of public welfare and to remove economic disparity.<sup>74</sup> Thus we can see that the equality of all citizens under Article 25 is violated where citizens are taxed in such a way as to achieve economic equality.

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formation for selection is essential due to the nature of this function which involves the use of taxpayer specific information at both levels. In addition, the process of selection of cases and performance of audit should be totally transparent in order to develop trust between taxpayers and the administration. Further, for any tax administration to operate efficiently and honestly some prerequisites such as sufficient skills, high remuneration, appropriate performance evaluation mechanisms and suitable internal controls are mandatory in general and necessary for the success of SAS in particular.

In terms of making the criteria for taxpayer selection flexible in Pakistan, it is suggested that ss 177 and 214 should be accordingly amended. The criteria for selection should not be provided in law and the function of designing criteria should be delegated to the tax administration so that it can be resilient and able to be adjusted each year in accordance with the facts of that year. As noted above and seen in the good practices of developed countries, better selection relies on collaboration between the central office and field formations. Such collaboration ensures the optimum use of centrally prepared data. Analysis is done with both the formal (generally prepared data) and informal (with local formations) data.

