

## THE ISSUES OF TAX RISKS CALCULATION AND MANAGEMENT

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## Abstract

In any private company in Latvia there are three main issues in the field of tax risks calculation and management: how to calculate the possibility of tax risks occurrence, how to estimate the amount of reserves for covering unforeseen losses, choice of the optimality criterion for selecting one of the possible solutions. The article deals with three features and two major causes of tax risks, as well as several stages of calculating risks and choosing the best option of possible management solutions. The optimality criterion proposes the amount of probable losses within the limits of acceptable risk. In the Balance Sheet the value of this zone varies around the accumulated profit and reserves.

Tax payments procedure has its own peculiarity: tax payers have to interpret independently statutory provisions, which appear unclear, ambiguous or contradictory to them. Not all taxpayers undergo audit, not all taxation periods and not all taxes are being verified. Tax payers can calculate the probable amount of the claim in advance, if they independently take the decision on tax payment under conditions of uncertainty of tax statutory provisions.

Tax risk diagnostics can be carried out and based on two figures - possible risk cost and probability of the event "X" that there is an audit by Tax Administration Service and its decision on imposing a tax penalty. Tax risks should be an important element of entrepreneurial risks (including financial risks) for the benefit of efficient administration.

Every private company could estimate its tax risk cost. At the first stage it is important to carry out the complex job of analysis of regulatory documents concerning taxation, i.e. applicable laws and rules of. At the second stage the taxpayer compiles all options based upon the structure of of each statutory provision. At the third stage the possible sanctions are calculated (penalty and late payment fee). Then an idea of possible risk costs due to misapplication of statutory provisions is being formed. At the fifth stage chances of lowering tax penalties are estimated. Then the sixth stage follows, where the total possible risk cost and its influence on the tax payers' financial position is evaluated.

The methods and procedures of calculating the probability of an audit and application of the tax penalty have already been described in the literature. The Delphi method, described by V.M.Popov for financial risks, is mainly used for this purpose. But it is also possible to conduct calculation of probability verification's facts towards taxpayer. The annual statements may be used for this purpose by Tax Administration. Thus, there were approximately 162 thousands active operating tax payers (legal persons) registered with the tax administration in Latvia in 2010. There were only 1682 audits conducted in 2010, that is 2% of all verifications. That means that the probability of audits for each tax payer comes to no more than 2%. Probability of audit calculated by the same method for years 2005 and 2006 had also come to 1%. So, tax risks management should be conducted under the conditions of uncertainty and instability of tax legislation .

**Keywords:** partial uncertainty, tax risk, unstable tax system, financial and accounting policy, acceptable losses zone, probability.

## Introduction

*The scientific problem* is the lack of research in the fields of the nature of tax risk, its calculation and management on macroeconomic and microeconomic levels. In practice of business-consulting the necessity of calculation of tax risks has become an important element for adoption of management decisions in the field of entrepreneurial activity.

*Novelty* – the methods of tax risk diagnostics, estimation and reduction to the level of acceptable losses are suggested .

*The aims* of this article are to analyze the tax risk reasons, to show stages of estimation of losses connected with tax risk and to determine the levels of acceptable, critical and catastrophic risk.

*The object* of this article is tax risks of a private company as they occur when the country's tax system is characterized as unstable and unclear.

*The research methods* of tax risk analysis (method of scenario, method of losses and gains, method of statistical

data) used in this article are based on the neoclassical approach to risks' nature and on probability theory.

## Subject's relevance

Tax risks in a risk-management's scientific and study literature have not been researched practically [1-4]. The place for them in the currently accepted risks' classification has not been specified [5-7]. Sometimes the researchers mention tax risks as a part of political force-majeure risks [8] that do not quite precisely reflect their nature.

Nevertheless, in practice of business-consulting the term "tax risks" has assumed its firm position among financial risks [9-14, 20]. The necessity of losses' records connected to their occurrence has become an important element of management decisions. In relation to this, the difficulty of calculation of the tax risks amount and selection of its mitigation technique emerges.

For the solution of this problem it is expedient to

choose those risk-management specialists' and experts' recommendations, that may be applied to the risk of additional (unplanned) tax payments in the budget, i.e. the tax risks.

The risk, as a probability of occurrence of unforeseen expenses, is always present in any entrepreneurial activity. The tax risk is a form of financial risks. It represents a possibility of occurrence of financial liability, i.e. claims concerning the amount of mandatory tax payments and duties to the budget imposed by fiscal bodies. Furthermore, the unexpectedness of additionally claimed tax payments is highly relative. It is related to the specific features of the tax payments procedure.

First, the majority of such mandatory payments are calculated and paid by tax payer into the budget independently, based on requirements of government regulations. In addition, tax audit and discovery of mistakes in tax calculation cannot be an absolutely unexpected event for a tax payer. The fact of occurrence of a claim on the part of fiscal bodies as such is expected always.

It becomes clear, therefore, why 33% of the residents in Latvia surveyed in December 2010 have responded that non-predictable and ambiguous nature of tax legislation is the main cause of evading tax payments. Another 58% believe that the governmental policy in the field of taxation gives raise to hidden economy [15].

However, not all taxpayers undergo audit, not all taxation periods and not all taxes are being verified. Claim to the figure of released tax payments on the part of fiscal bodies is accorded only to the tax payer as an opportunity, but not as the imminence. Therefore, additional tax payments into budget are considered by entrepreneur as a probability, i.e. as a risk.

Second, in calculation of taxes an entrepreneur relies upon the regulatory system that is available to him/her. Furthermore, a tax payer has to interpret independently statutory provisions, which appear unclear, ambiguous or contradictory to him/her. The tax administration cannot help the tax payer in this respect, since it is not eligible to interpret statutory provisions in Latvia. Therefore, the tax payer is always aware of the situation wherein a contradiction between two different interpretations of statutory provisions may occur during an audit. Only the court can resolve contradictions between viewpoints of a tax payer and viewpoints of the tax administration. Just as the court judgment is not known to anybody by anticipation, the necessity of payment of additionally accrued sums into the budget is perceived by a tax payer as a probability. *Videlicet*, the realization of the presumptive tax risk is becoming totally unexpected for a tax payer; he/she cannot forecast additional expenses. Yet, the situation of occurrence or non-occurrence thereof signifies that the tax risk remains as the essence of these expenses.

The third circumstance is the one that confirms the thesis of relativity of unexpectedness of emerging tax claims to an entrepreneur. The fact is that a tax payer can calculate the presumptive figure of the claim in advance, if he/she independently takes the decision of tax payment under the conditions of uncertainty of the tax statutory provisions. The amount of claim (sanctions) is composed of three elements: tax unpaid in time, late payment fee and penalties for payment, that can add up to 30% and 50% of the unpaid tax, it might also be higher: 70%, 100% and even 300% (employer's mandatory social insurance payments)[16]. The tax payer can rapidly change the adopted tax decision by paying the main

debt, penalty and 10% of the fine. in this way the tax payers will avoid sanctions, since they voluntarily have accepted the fact of paying a part of expected sanctions, i.e. the realization of the unexpected risk. Yet, they may pay nothing and wait for conclusion of the audit. In fact, it is purely possible, that their interpretation of the faint statutory provision may coincide with the auditor's interpretation. In that case, the risk of unexpected expenditure disappears.

The essence of tax risks (probable occurrence of the previously unplanned tax liability) emerges not only as tax sanctions on the part of fiscal bodies - requirements to pay an additional amount of tax, penalty and fine. The second equally important aspect of this is represented by changes of tax legislation. In the period of rising budgetary deficit, Latvian tax payers have already experienced a sudden increase of value added tax rates. The debates concerning further stiffening of the tax legislation's are expected, these are as follows: increase of the exercise goods tax rates, the appearance of new taxable objects and lifting the currently existing preferences (exemptions, discounts, remissions, delays).

### The reasons of tax risks

Consequently, there are different reasons of occurrence of tax risks'. The imperfection of tax legislation in a country may be considered as one of the reasons behind tax risks. These are doubtfulness and ambiguity of some tax laws provisions, in the first place. The unpredictability of the legal system comes second. This situation is especially characteristic of Latvia where tax laws are changed every 2-3 months. They are adopted in a hurry and therefore they cannot be well thought-over. Under such conditions each new legal requirement can be interpreted in different ways. There is a possibility that both tax payers and the tax administration can adopt many different decisions. This is where the tax risk is born – a risk of additional tax payments (sanctions) by the taxpayer and the risk of not collecting expected budget revenues (see Table 1).

### Quantity of amendments in main tax laws in Latvia

The name of tax law \ years	2007	2008	2009	2010
Taxes and duties (general law)	3	3	6	8
Corporation income tax	2	1	5	4
Personal income tax	3	3	3	5
The value-added tax	1	3	3	3
Social tax payments	2	2	3	3

Concerning this reason it is necessary to understand that changes of tax legislation are a real necessity. The "stability" in this content cannot mean firmness of accepted standards. Yet, the necessity and possibility of medium-term perspective planning of processes have been proven by scientists long time ago. For that reason, the stability of tax legislation, first,

means the accepted innovations scientific justification; second, the specification of the minimum validity term of these norms (a year, one, two, three); third, strict abidance of a transition period (it can be, for example, from three to six months), i.e. time between the date of adopting a new statutory provision and the date of its entry into effect. So, imperfection of the tax legislation is the main reason behind the tax risks. Undoubtedly, there are other taxpayers' mistakes and dishonesty.

It may be explained by the attempts of businesses to survive under the circumstances of economic crisis and the ongoing depression: the Gross Domestic Product of the country has decreased to minus 18% in 2009 and minus 0.4% in 2010. [17].

The question about subjectivity and objectivity of these reasons cannot receive a univocal answer. That is why the analysis of other reasons of tax risks must be carried out, including peculiarities of different taxpayer groups.

Nevertheless, it is safe to distinguish several factors that intensify or vice versa enfeeble tax risks at different management levels. In the first instance, these are personnel or educational and accounting policies for circumstances of Latvia. The amount of the tax risks and their probability incase of different taxes depend on how targeted this policy is and what is the degree of sophistication in the state and an independent private company.

Evaluation of efficacy of these factors is always carried out at the level of a certain taxpayer with differing degrees of awareness, therefore, the diagnostics of tax risks is in progress.

It is possible to conclude that tax risks present an objective reality in the entrepreneurship. They may be referred to political risks by virtue of nascence that is tax statutory provisions' vagueness, divergent or theirs sudden super session. They are dual by their own nature for the reason of subjective and objective origination causing partial uncertainty on the levels of micro- and macro- economy. They should be considered financial risks by scope of nascence and losses' nature. Nonetheless, if latter may be speculative by nature, then tax risks are always pure and static.

### Stages of calculating the risks

Such characteristics of tax risks (in terms of generally acknowledged classification features of risks groups) enable to perform their diagnostics and monitoring. At the first instance, the complex job in analysis of regulatory documents in taxation scope is essential, i.e. applicable law and rules. The aim of such analysis is to reveal current for a company, but vague and divergently interpreted statutory provisions. At the second instance, the taxpayer compiles something like a worksheet of tax rates benchmarking study according to all possible options based upon interpretation of each statutory provision. This suggestion was stated by K.Ketners in issues of 2007 and 2008 [10,18].

At the third stage of diagnostics the possible sanctions are calculated (penalties, late payment fee and general debt), if it is assumed, that tax administration will interpret statutory provisions differently from the tax payer. Consequently, an idea of possible risk costs due to misapplication of statutory provisions is being formed.

At the fifth stage chances of lowering tax sanctions are estimated. That can be done by means of two techniques:

1. application of tax penalties' discounts to tax payers refusing an appeal of tax administration's decision,
2. application of conciliation agreement with the tax administration and complete lifting of the fine imposed on the tax payer [19]

Next is the sixth stage, where a total possible risk cost and its influence on tax payers' financial position is evaluated. It is known, that in the risk-management it is not advisable to take decisions which result in probable losses exceeding the limits of the allowed risk envelope (company's accumulated income and reserves). Losses penetration in a critical and more irretrievable risk envelope signifies that analyzable employment option in conditions of uncertainty of actual statutory provision should not be given a consideration, even if such situation's probability is low.

### Calculation of probability

The diagnostics of tax risks, as it follows from the above, must be based on two figures- possible risk cost and probability of the event "X" that there is an audit by Tax Administration Service and its decision on imposing a tax penalty.

The methods and procedures of calculation of probability of audit and imposition of the tax surcharge have already been described in the literature [20]. The Delphi method, described by V.M.Popov for financial risks, is mainly used for this purpose [21]. It is also possible to conduct calculation of probability verification's facts towards taxpayer. The annual statements may be used for this purpose by tax administration. Thus, there were approximately 162 thousands active operating tax payers (legal persons) registered with the tax administration in Latvia in 2010. There were only about one thousand audits conducted in 2010, that is less than 1% of all verifications [22].

### Tax audit probability in Latvia

Indications	2009	2010
Total amount of tax payers (legal persons)	151,476	161,895
Total amount of tax audits (legal persons)	807	987
Tax audit probability (%)	0.53	0.61
Average tax penalty per audit (thousands LVL)	113.3	110

One has to keep in mind that the probability of audit calculated by the same method for years 2005 and 2006[20] had also come to 1%. So, the probability of a tax audit is quite low. However, the amount of possible penalty is large enough. As we can see from Table 2, each audited taxpayer pays a sanction amounting on average to 100 thousand LVL (about 200k \$).

The final decision, about which interpretation of a statutory provision should be chosen by a tax payer, must be taken after considering various factors. The main ones among them are risks cost and probability of audit. Yet, other factors are equally important, the search and evaluation of which refer to scope of monitoring and to present risks dynamics' tracking. There is a possibility of winnings in decision's appeal among them. Some of taxpayers appealed against tax surcharges. In 10% cases the decision was partially or entirely revoked. This

means that monitoring provides a low probability of victory in appeal, it is pointless to reckon on it.

### Conclusions

In conclusion, several overall conclusions can be made:

- tax risks must be distinguished within the totality of entrepreneurial risks (including financial risks) for the benefit of efficient administration
- tax risks management must be conducted in micro- and macro- economics under the conditions of uncertainty and instability of the tax legislation
- at a private company a possibility of calculation of occurrence of tax risks exists
- there is a possibility to lower the tax risk in a private company

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