

## **CASE STUDY**

# **Tax Inspection – Unlawful Interference**

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**Abstract:** This article focuses on the issue of options, respectively the scope of application of the tax authorities' discretion in the use of available instruments to ensure the objective of tax administration, i.e. the correct identification and determination of the tax and its payment.<sup>1</sup> The article is based on a case study of the decision of the Supreme Administrative Court of the Czech Republic.

**Keywords:** tax; additional taxation; tax inspection

## **1. Introduction**

The result of the decision of the Supreme Administrative Court of the Czech Republic, which is analysed in this article, is the declaration of the unlawfulness of the tax inspection. As it might seem at first glance, the problem was not, as in many cases before, in the incorrect procedure of the tax administrator at the beginning of the tax inspection, the definition of its scope or its length. Tax inspection has been dealt with in many decisions. For example, the decision of the Constitutional Court of 8 November 2011 (Pl. ÚS 33/11) deals with the possibility of the tax administrator to initiate tax inspection. The Constitutional Court noted that, after previous differences in decision of courts, tax inspection can be initiated by the tax administrator even without specific reasons and suspicions. But in the analysed case, the court deals with the question whether the tax administrator should have used other, less burdensome means before the tax administrator proceeds to tax inspection.

The problem, and therefore the reason for dealing with the above mentioned issue, is, of course, the consequences of the taxpayer's undue process, which in a certain sense may depend on the decision of the tax administrator whether he notifies the taxpayer or initiates the inspection. De facto, it is also the question whether the penalty payment under section 251 of the Tax Code is imposed.

In practice, it will be important whether such a mistake is one-off or repetitive. This is related to another issue, namely the categorisation of tax subjects, which would be the issue of self-employment and the motivation of one or the penalisation of others. It is the same in substance but depends only on the point of view. Hungary has chosen the system of motivation. The question is how this system will develop and whether the responders who

will have no benefits will claim to be sanctioned. Perhaps, in fact, the probability of tax inspection will be higher. In addition, in such a motivation system (of course, it depends on its particular setting), it must necessarily be that all of the taxpayers are initially classified in category 0. If they will fulfil the obligation properly, they will proceed to categories 1, 2, etc. It can be assumed, in such cases when there is a majority of such entities that those who fail to fulfil the obligations will remain in category 0, and de facto, this group corresponds to a group that could be ranked on the basis of another criterion, the opposite one.

## 2. Legal Regulation

This is the interpretation of Section 143 (3) of Act No. 280/2009 Coll., The Tax Code, as amended (hereinafter the Tax Code). The issues are, whether the tax administrator should use firstly means in accordance to the client's approach and notify the taxpayer (although the taxpayer was already in delay with the tax assessment; the tax entity set the tax, but it was suspected to be incorrect).

The Supreme Administrative Court tried to define a very thin line when the tax administrator has to notify the taxpayer to fulfil his duties additionally, and when he has to choose another procedure, harder, more powerful to get the data himself. In the first case, the tax administrator takes care of the welfare of the individual and alerts the inattentive addressee of the self-enforcement legal norm. This costs a lot of money, and of course it is true that the money is paid by other honest and supervised tax payers. In the decision, the court also refers to the basic objective of tax administration, but in my opinion the payment security is insufficiently accented.

To analyse this case, it is necessary to focus on the following legal rules, respectively individual concepts and institutes, which are interpreted in the decision of the Supreme Administrative Court. This is a situation where the taxpayer filed a proper tax claim, but there was a situation where the tax administrator had doubts about its correctness, and the issue is how the tax administrator should properly react.

It responds to this situation defined in the framework of Section 145 of the Tax Code – Procedure for not submitting a proper or additional tax return.

*“(1) In the absence of a proper tax return, the tax administrator prompts the taxpayer to submit it and sets a substitute period. If the taxpayer fails to comply with this notice within the specified time limit, the tax administrator may assess the tax by means of utilities or assume that the taxpayer claimed a tax of CZK 0 in a regular tax return.*

*(2) Where it can be reasonably assumed that the tax is to be taxed additionally, the tax administrator may prompt the taxable person to submit an additional tax return and set a substitute period. If the taxpayer fails to comply with this notice within the specified time limit, the tax administrator may levy tax on the aid (on his behalf).”*

Furthermore, Section 143 (3) and (2) of the Tax Code should be mentioned.

*“(1) The tax may be based on an additional tax return or an additional bill, or ex officio. The legal power of the existing tax assessment decisions is not an obstacle to it.*

(2) *According to the results of the arbitration procedure, the tax administrator shall tax the difference in the amount of the last known tax and the newly established amount, and he shall simultaneously prescribe the calculated tax difference in the tax records; additional tax assessment for direct payment of the taxpayer is also understood as taxation.*

(3) *Additional tax assessment ex officio may occur only on the basis of the result of the tax inspection. If the tax administrator discovers new facts or evidence except the tax audit, on the basis of which it can be reasonably assumed that the tax is to be additionally assessed, tax administrator proceeds according to Section 145 paragraph 2.”*

It was clear from the facts of the analysed case that the tax administrator had apparently quite specific information and documents, that he could even assess the tax (of course, he could not be sure what causes the error). Thus, the tax administrator could use the procedure to remove the doubts, and in fact, to point the taxpayer to the error. He did not have to prompt to submit an additional tax return. And, according to the results, if the doubts were not scattered and the taxpayer did not submit the additional tax return, the tax administrator could initiate a tax inspection with the aim of detecting the necessary facts. The procedure is governed by Section 89 of the Tax Code:

*“(1) If the tax administrator has specific doubts about the correctness, veracity or completeness of the proper tax return or additional tax return and other documents submitted by the taxpayer or the truthfulness of the data contained therein, the tax administrator prompts the taxpayer to remove doubts.*

*(2) In a tax administrator’s prompt, the tax administrator raises doubts in a way that will allow the taxpayer to comment on it, complete the incomplete information, explain the uncertainties, prove the untrue data, or prove the truthfulness of the data, and provide evidence to eliminate these doubts.*

*(3) In the prompt, the tax administrator sets a deadline for the elimination of doubts, which shall not be shorter than 15 days, and inform the taxpayer of the consequences associated with the non-removal of doubts or non-observance of the deadline.*

*(4) Where it is clear from the proper tax return or the additional tax return that the taxpayer is liable to a tax deduction, the tax administrator shall, in case of doubt, issue a prompt for the elimination of doubts within 30 days from the date of such tax return submission but at the earliest from the last day of the deadline set for submitting a proper tax return or an additional tax return.”*

In this way, the tax administrator would dispel his doubts about the correctness of the tax, perhaps he would have found out, although this is not primarily a key one, and it is irrelevant for determining of the tax, why the tax payer did not give this information to the tax administrator (as an argument in the cassation complaint, it looks somewhat ridiculous).

### 3. Case Study

In view of the possible unlawful interference in the form of tax inspections initiated by the tax administrator, the Supreme Administrative Court assessed a cassation complaint by the Financial Office against a taxpayer at its meeting on May 6, 2015.<sup>2</sup> The tax administrator

demanded the annulment of the Regional Court's decision finding the illegality of the tax inspection.

Since the tax administrator had doubts about the amount of the submitted tax, in particular, the tax administrator considered that the taxpayer did not include the income relating to the real estate change contract in 2010. The tax administrator therefore initiated the tax inspection and could consequently establish the tax *ex officio*.

The tax entity, however, opposed the fact that the tax administrator did not proceed properly and took advantage of the tax inspection institute prematurely. Referring to Section 143 (3) of the Tax Code in conjunction with Section 145 (2) of the Tax Code, the taxpayer should first have been prompted to submit an additional tax return if the tax authority had at this time information (obtained expect the tax inspection) on the basis of which he could reasonably assume that the tax will be set additionally.

In this case, it was demonstrably established in the proceedings before the Regional Court that the tax administrator was convinced (by his search) that the value of the exchanged real estate was not included in the personal income tax base. He also had at his disposal a contract of exchange and expert judgment of the land exchange valuation (on the basis of which it is possible to determine the tax). The Tax Administrator stated in his defence that he had begun a tax inspection to dispel doubts, referring to the results of the tax inspection, which should determine whether and in what specific amount the tax would be set additionally. In addition, he also wanted to find out "why" the taxpayer did not provide the information.

The tax administrator, however, defended the conclusions of the Regional Court<sup>3</sup> and argued that it was not possible to reliably assume the reasonableness of the additional tax assessment before the initiation of the tax inspection. He also argued, referring to the ruling of the Supreme Administrative Court,<sup>4</sup> that although it is necessary to choose a procedure which, in the circumstances, best accords with the principle of restraint and proportionality, on the other hand, the tax administrator may proceed to tax inspection immediately if he has good reason to believe, that another approach would not suffice to achieve the purpose of tax administration. In order to decide whether to initiate a tax inspection or to prompt the taxpayers to submit an additional tax return, it is essential to take into account the principle of effective security of the basic tax administration objective.<sup>5</sup>

The Supreme Administrative Court first analyses the explanatory memorandum to the Tax Code in relation to Section 145 (2) of the Tax Code and focuses on the part where the principle of speed is accentuated according to which the tax administrator should proceed in case of various findings so that the tax returns are submitted with respect to the primary way of fulfilling the duties of the taxpayer – the obligation to submit, analogously also in the additional procedure. According to the explanatory memorandum, it is at the discretion of the taxpayer to submit a tax or allow the tax administrator to charge the tax on his behalf.

In addition, the Supreme Administrative Court also notes the differences in the legislative capture of rules under Section 145 of the Tax Code. In the analysed case, although the second paragraph of the provision is essential, but as the tax administrator correctly states, the provision of paragraph 1 states that the tax administrator does not have the

possibility to consider (*“the tax administrator prompts”*), but in case of additional tax returns the provision of paragraph 2 provides the possibility (not obligation) of the tax administrator (*“the tax administrator may prompt”*).

Furthermore, the Supreme Administrative Court expresses in its decision on §143 (3) of the Tax Code and states that the explanatory memorandum shows that: *“the tax administrator will either find out in the framework of the tax inspection and will impose a tax on the result, or the tax administrator obtain by another means evidence that a change in the last known amount of the tax is needed, the tax administrator prompts the taxpayer to submit an additional tax return or an additional bill.”*<sup>6</sup>

The Supreme Administrative Court first considered the interpretation of the reasonable assumption by analysing the above-mentioned provisions and also relied on the fundamental principles of tax administration and interpretation in the spirit of the fundamental principles of tax administration. He states that the notion of “reasonable” as “for sure” cannot be understood. It further states that, the condition of a reasonable presumption of additional tax establishment is not only the situation in which the tax administrator would be able to determine the tax in a specific amount on the basis of information obtained apart from the tax inspection. It argues quite logically when it states that this situation is unlikely, but rather common, the situation in which the tax administrator finds out that the tax return does not contain specific tax-related facts and it can already be assumed that the tax will be additionally established. That means that if it is found that the tax return is incomplete, it can generally be assumed that the tax will be established additionally, regardless of its final amount (which is irrelevant, and the law does not even mention a specific amount).

The prompt of the tax administrator is referred by the Supreme Administrative Court as an *“instruction to allow the taxpayer to fulfil its obligation”* and as a reflection of the principle of proportionality and restraint.<sup>7</sup>

I cannot agree with this statement (the “instruction”). The taxpayer has the possibility to submit the additional tax return even without the tax administrator’s prompt, in particular time limits.<sup>8</sup> In general, it would be more likely to refer to the tax administrator’s prompt (after fulfilling the legal conditions) as a reflection of the principle of client access and, where appropriate, restraint.

The Supreme Administrative Court furthermore deals with the analysis of Section 145 of the Tax Code. It understands it as a prerequisite for effective tax administration, with regard to the number of taxable entities and related tax obligations. I can agree with this statement and further, it is necessary to highlight the close connection with the method used to require tax-related obligations, namely self-enforcement. The Supreme Administrative Court also notes the fact that in practice there is a demand for correct and complete identification and determination of the tax (there is a certain probability of incorrect data) with the factual reliability of tax proceedings with a large number of subjects. Here it is necessary to add more in connection with the inspection part of the tax proceedings, especially when it is not performed on a voluntary basis, properly and on time. Moreover, this widely understood control (and search) activity of the tax administrator is a basic and necessary prerequisite for the functioning of tax administration and self-enforcement, i.e. the result of the prevention principle and a certain motivation to

properly discharge of the duties, thus ensuring efficient administration and the process of tax collection.

Following the mentioned provision which deals with a situation where the taxpayer did not at all submit tax, the Supreme Administrative Court interprets the provision of the second paragraph of that Section, which provides that the tax administrator may prompt when it can be reasonably assumed that the tax will be additionally established. The situation where the tax return is not submitted at all, consumes the provisions of the first paragraph. In such case, the tax administrator must prompt. In addition, in the provision of paragraph 2, the legislator would refer to the assessment of the tax, not the additional assessment.

When the tax return is submitted, but apparently incorrectly and there is a reasonable presumption of additional assessment, the tax administrator can prompt. However, the Supreme Administrative Court interprets this provision in the opposite way, as the possibility of the tax administrator in certain cases “not to prompt” the taxpayer and to initiate tax inspection, i.e. to intervene lawfully in the rights of the taxpayer. At the moment, in the opinion of the court, the interest in the correct assessment of the tax with the efficiency and feasibility of the tax procedure prevails and justifies the fact that the legislature did not necessarily assume the same number of prompts according to the additional establishment of tax as the number of proper tax returns. This can generally be accepted, but I cannot agree with the used justification. The Court therefore interprets paragraph 1 as the general duty of the tax administrator to always prompt, and paragraph two as a specific limitation of that option where the tax controller reasonably assumes. This somewhat denies both the verbal and the systemic interpretation of this paragraph.

#### 4. Conclusion

On the basis of a procedural analysis of the situation, taking into account the system of tax procedure and the fact that paragraph 2 deals with additional taxation, tax inspection can be understood as a certain *ultima ratio* that may occur within the deadline for additional taxation. In general, there is still a prerequisite for self-enforcement, as in the proper assessment process, i.e. the taxpayer itself may detect a mistake in his submission and may change it. It is impossible to rely on the fact that the tax administrator will reveal most of the mistakes. The system works on prevention and voluntarism, and assumption that the tax inspection can be carried out.

In practice, there will be fewer cases where there will be a reasonable presumption of additional taxation. The assumption is always here, as the court said, but it can result from the statistical fact that the legal rules are not always met on a voluntary basis and therefore the coercion exists. This, of course, cannot and I do not want to criminalise every addressee of the legal norm, respectively taxpayer in this case.

It should also be taken into account the fact that a potential prompt is already part of an additional taxation procedure, i.e. the phase, when the taxpayer must assume that the tax administrator will verify his tax liability, whether by random check, suspicion of own

investigation (search activities) or statement of a third person. And the taxpayer had the opportunity and sufficient time to submit turn return properly in the original date.

Therefore, if there is a reasonable expectation and at the same time, there is no risk of non-taxation and avoidance of taxation, the tax administrator should, respectively, must prompt the taxpayer, especially with regard to the principle of economy, client access and the primary method of applying tax law rules – self-enforcement.

Efficiency and feasibility of the tax administration cannot be perceived as opposed to the requirement of correct tax assessment, quite the contrary. In many cases, the need for legal (quick) intervention in the taxpayer's rights will be more effective, especially in the event of a recovery phase. In addition, the possibility of tax inspection must be perceived as a preventive and effective tool for the effective functioning of the voluntary system of self-enforcement.

This situation could also be seen through the eyes of other taxpayers and the principle of equality. They may feel affected that the tax administrator has not also prompted for an additional tax return, taking into account the fact that the tax administrator has not pursued conscientiously his search-control activity and has not found their mistake.<sup>9</sup>

This would *de facto* mean in an extreme case that before initiation of the tax inspection, especially if it is random, the tax administrator should obtain all possible information about the transactions and legal facts of the taxpayer, in particular from the databases and the automated approach, as well as from other public authorities. Only after that he would be able to initiate tax inspection without the risk of any indication of the inspection being illegal.<sup>10</sup>

The tax administrator has the possibility (not the obligation) to prompt also with regard to the principle of economy of tax administration. Although there may be a fact that indicates the incorrect data in the tax return, but this may not automatically imply a presumption of additional taxation.

It may happen that, despite some income is not included, the resulting tax does not change, for example because the taxpayer's discount was not fully consumed. That means that the lack of information does not automatically affect the resulting amount of tax. The opposite situation is Section 141 (1) and (2) of the Tax Code which states that the taxpayer is obliged to file an additional tax return if he finds that he has a higher tax liability and can file it, if the tax is the same or lower. Again, with regard to the principle of economy, the negative difference in the calculated tax (the part will be refunded) may not be automatically economically efficient for the taxpayer because it means to fulfil the tax return again (additional costs).

Therefore, it is not possible to force the taxpayer to submit additional tax return if the tax would have been the same or lower, only to have it "correctly" in the evidence of the tax administrator. It is a manifestation of the principle of the material state which appears in many decisions of the Constitutional Court.

In this particular case, I consider essential the tax administrator's weak argumentation, the lack of explanation of the facts and, in the least, the weak defence of the principles of tax law and the public interest in the form of an obligation to proceed in such a way that the tax is determined and secured. The need to act preventively and motivational, even in the form of a threat of sanctions is also very important. The court itself stated the practical

and factual impossibility of inspection of each entity. This is all the more necessary to ensure a clear interpretation of the norms and to act educationally that the fault will be followed by the consequence (the principle of economy and speed of administration). It is not possible to educate in a constant need to prompt any addressee of any rule.

Tax inspection should also be perceived from a certain point of view as a manifestation of power intervention, the *ultimate ratio* leading to the objective of tax administration specifically according to the tax of a particular taxpayer.

It can be agreed that the tax administrator should be guided by the principle of reticence for its application, for many reasons on the side of the taxpayer, but also with regard to the principle of economy. Inspection itself is not an easy task, and it is very costly for the tax administrator because it also involves many procedural obligations to ensure a fair process.

In addition, the tax administrator should be more lenient, especially in case of “errors in writing and errors in numbers” in tax returns, respectively in situations when the taxpayer communicates the material information, for example in the form of an attachment, but does not fill the right so-called “box”. It always depends on a particular tax administrator, but in general it can be said that this approach is applied.

In the analysed case, the tax administrator obviously had a reasonable prerequisite for additional taxation and did not proceed in accordance with the legal regulations. It follows from the facts that the tax authority was required to prompt the taxpayer. The problem could arise in situations when the prompt could endanger the determining of the tax in correct amount, obscuring information about other unapproved revenue or transactions, and this could lead to the tax administration being thwarted. With this, the tax administrator did not completely deal with in his submissions, and this was not proven.



## References

- 1 Section 1 (2) of the Tax Code.
- 2 Supreme Administrative Court: 2 Afs 209/2014.
- 3 On the grounds of the judgment under appeal, the Regional Court concluded that before initiating the tax inspection, the tax administrator had sufficient specific information which allows him to choose the procedure proportionally, namely the tax administrator should prompt the taxpayer to submit additional tax return. Referring to the decision-making activity of the Supreme Administrative Court, the Regional Court added that limiting the personal sphere of an individual by the tax administrator's duty to carry out tax inspection must follow a legitimate aim and be appropriate, necessary and proportionate in relation to that objective. Thus, if the conditions for the procedure under Section 145 (2) of the Tax Code were met, the tax administrator could not proceed to the most burdensome procedure – proceed to the tax inspection. The Court thus deduced that the tax inspection was an unlawful interference from the beginning.
- 4 Constitutional Court: 5 Afs 92/2008-147.
- 5 Constitutional Court: 5 Afs 92/2008-147.
- 6 Supreme Administrative Court: 2 Afs 209/2014.
- 7 See Section 5 (3) of the Tax Code.
- 8 See Section 141 of the Tax Code.
- 9 Information from parallel proceedings.
- 10 Kobik also draws attention to the principle of equality (see Jaroslav Kobík, *Daňový řád s komentářem* [Tax Code with Commentary], 2<sup>nd</sup> edition, 741–742 (Olomouc, Anag, 2013).