**FOR INFORMATION**

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# TECHNICAL ASSISTANCE REPORT

# KINGDOM OF LESOTHO

## REPORT ON DATA MATCHING OF CUSTOMS AND TAX DATA

January 2020

**PREPARED BY**

*Robert Tait*

AFRITAC South

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# ACRONYMS

| | |
|---|---|
| AFRITAC | Africa Regional Technical Assistance Center |
| AFS | Regional Technical Assistance Center for Southern Africa |
| ASYCUDA | Automated System for Customs Data |
| CG | Commissioner General |
| CIF | Cost, Insurance, and Freight |
| CIT | Corporate Income Tax |
| DM | Data Matching |
| DT | Domestic Tax |
| ETPM | Enterprise Taxation & Policy Management System |
| FAD | IMF's Fiscal Affairs Department |
| FOB | Free on Board |
| IMF | International Monetary Fund |
| ISIC | International Standard Industrial Codes |
| IT | Information Technology |
| LRA | Lesotho Revenue Authority |
| PAYE | PAYE |
| RBM | Results Based Management |
| STX | Short-term Expert |
| TA | Technical Assistance |
| TCC | Tax Clearance Certificate |
| VAT | Value Added Tax |

# EXECUTIVE SUMMARY

**The aim of this mission was to assist Lesotho Revenue Authority (LRA) to develop the capacity to analyse data and to make use of that data to support a risk-based approach to compliance management.** The LRA project team followed the standard Data Matching (DM) methods, steps, and procedures. The team is now capable of performing future data matches without the need for additional technical assistance (TA).

**The findings indicate a troubling quantum of likely non-compliance and revenue risk across a wide range of areas.** Each of the top 94 importers (75 percent of import trade value) were assessed against 75 risk indicators. Each of the top 23 exporters (75 percent of export trade value) were assessed against 58 risk indicators. Both major importers and exporters were given individual risk profile scores and prioritized for follow-up action.

**Businesses are routinely reporting different levels of business activity to each of the three business lines.** LRA is not adequately monitoring and managing the declaration/returns across business lines. The trade value quantum of anomalies detected, is shown at Table 1 below:

**Quantum Value of Trade Risk (M Billions) in Priority Order (2017-18)**

| **Risk Category – Largest Importers 2017-18** | **M Billions** |
|---|---|
| Cost/Insurance/Freight (CIF) Import Values declared to Customs >< Import Values declared on Value Added Tax (VAT). This includes possible customs undervaluation of M .2 B) | 7.8 |
| Sales on VAT return vs Sales on Income Tax return | 6.4 |
| Purchases on VAT Return vs Purchases on Income Tax return | 2 |
| Net profit/loss on Income Tax return vs Average Profit/loss for sector | 1.2 |
| Sales Suppression Suspected (imports + local purchases vs VAT sales) | .9 |
| PAYE return remuneration vs Corporate Income Tax (CIT) remuneration | .9 |
| VAT paid at Customs > < VAT claimed on VAT return | .4 |
| Total import | 19.6 |
| **Risk Category – Largest Exporters 2017-18** | **M Billions** |
| Free on Board (FOB) >< VAT Zero rated sales | 1.3 |
| CIT export sales >< FOB | * |
| CIT export Sales >< VAT Zero rated sales | * |
| Total export | 1.3 |
| **GRAND TOTAL at risk** | **20.9** |

*no data as export sales not recorded on the CIT return

**Revenue generation potential appears to be significant but cannot be quantified at this time.** Further investigation and validation are required to determine the exact causes of the anomalies detected. They are likely to be a combination of reporting problems and revenue avoidance or evasion.

**Actions to address the key capacity gaps were discussed and agreed.** An action plan comprising 25 key activities was designed and agreed. Implementation of the action plan will address the identified potential compliance risks in a prudent and appropriate manner.

**Summary of agreed follow-up actions:**

| Ref: | ▪ Activities | ▪ Timescale |
|---|---|---|
| 1. | Arrange a seminar between the IT unit responsible for Applications Development and Business and Process Management with the Compliance Risk Management Department to improve communications regarding data extraction. | February 20 |
| 2. | Implement the proposed "Hold/Seize Order" to customs to compel tax compliance and debt payment. | April 20 |
| 3. | Enhance monitoring and control of "deferred accounts" to ensure all import VAT is paid. | April 20 |
| 4. | Amend the ETPM to input the CIT returns with "substituted accounting period." | April 20 |
| 5. | Design and deliver an awareness raising event to promote the importance of data as a key compliance tool throughout LRA, with priority emphasis on areas of greatest weakness including quality control, data entry, analysis, and performance indicators. | June 20 |
| 6. | Amend VAT, CIT and PAYE returns to include critical data for downstream monitoring and enforcement and align the ETPM system to the revised returns. | July 20 |
| 7. | Design and implement procedures to monitoring export reporting as part of a risk-based compliance program. | August 20 |
| 8. | Implement procedures for the adoption of a "focused audit" approach for companies with specific anomalies identified by the DM. | September 20 |
| 9. | Deliver advanced Excel/Access, analytics, and data extraction training. | September 20 |
| 10. | Conduct an exemption/concession review to strengthen downstream enforcement in this high-risk area. | December 20 |
| 11. | Implement procedures to leverage all customs privileges/licenses/special services arrangements to compel tax compliance and payment of debt. | December 20 |
| 12. | Complete an annual DM exercise. | December 20 |
| 13. | Complete and evaluate the implementation of the DM action plan. | December 21 |

# I. INTRODUCTION

1. **The aim of this mission was to assist LRA to develop the capacity to analyse data and to make use of that data to support a risk-based approach to compliance management.** The mission was undertaken by Mr. Robert Tait, AFRITAC South Customs Short-term Expert (STX), during the period November 11–22, 2019. The key tasks were to:

- Brief senior management on the benefits of data matching, the methodology, and the resource requirements.
- Deliver a workshop on the data matching methodology to a joint project team of customs and domestic taxes staff and initiate a data matching exercise.
- Request the relevant data and support the LRA project team to undertake a data matching exercise.
- Provide TA to the project team with the preparation of a report summarizing the results of the project and the follow-up activity required.
- Finalize an action plan detailing the activities to be undertaken to implement the results from the data matching exercise.

2. **The activities were linked to the following Results Based Management (RB) milestones:** (i) Customs and tax are able to conduct data matching analyses to identify risk; and (ii) DM used to reduce front end inspections and increased post clearance audit activity. An update on the status of these milestones can be found at Appendix I to this report.

# II. SUMMARY OF TECHNICAL ASSISTANCE ADVICE AND KEY FINDINGS

3. **The mandate of the DM project assignment was to initiate data matching processes to compare customs importer declaration data with domestic tax returns, and to compare Valued added Tax (VAT)** returns **to Corporate Income Tax (CIT) returns**. The objectives of the project were to: (i) identify taxpayer compliance anomalies across the three functions; (ii) identify and mitigate against the risk of non-compliance; (iii) promote voluntary compliance; and (iv) to generate revenue.

4. **LRA customs and tax officials performed the DM exercises with AFS support, over the period November 11 - 22, 2019**. As agreed in advance, 21 hand-picked LRA staff performed the analysis with STX support and supervision. The LRA team prepared a full report of findings and the Project Manager presented the findings to the Commissioner General (CG) and the senior

management team. The project team extracted and matched data from the Automated System for Customs Data (ASYCUDA World) and domestic tax (DT) Enterprise Taxation & Policy Management System (ETPM) system, to identify revenue and non-compliance anomalies (potential risks) in both functions.

5. **The DM team encountered significant data challenges**. The ASYCUDA World data extraction had to be performed three times, and the VAT extraction twice, and many top taxpayer's CIT data was missing from the ETPM system. The delay and data integrity issues resulted in the need to reduce the scope from a planned two-year DM to one year, and a reduction in scope from the ideal 80 per cent of trade value to 75 percent, to ensure the project was completed within the two-week period.

6. **LRA staff experienced some difficulties in extracting data**. The expert observed that IT staff are generally inexperienced and do not yet fully understand the business, while analytical staff are also learning the complexities of precise data extraction "asks". It was agreed that a seminar be arranged between the two sections to improve communications.

7. **The good practice DM action plan was customized for Lesotho.** The action plan includes details of the activities required to effectively manage the implementation of the recommended compliance improvement measures.

8. **Revenue generation potential appears to be significant but cannot be quantified at this time.** Further investigation and validation are required to determine the exact causes of the anomalies detected. They are likely to be a combination of reporting problems and revenue avoidance or evasion.

9. **The findings indicate a troubling quantum of likely non-compliance and revenue risk across a wide range of areas.** Each of the top 94 importers (75 percent of import trade value) were assessed against 75 risk indicators. Each of the top 23 exporters (75 percent of export trade value) were assessed against 58 risk indicators. Both major importers and exporters were given individual risk profile scores and prioritized for follow-up action.

10. **Businesses are routinely reporting different levels of business activity to each of the three business lines**. LRA is not adequately monitoring and managing the declaration/returns across business lines. The trade value quantum of anomalies detected, and the incidence of taxpayer generation of anomalies are shown at Tables 1 and 2 below:

**Table 1. Quantum Value of Trade Risk (M Billions) in Priority Order (2017-18)**

| **Risk Category – Largest Importers 2017-18** | **M Billions** |
|---|---|
| Cost/Insurance/Freight (CIF) Import Values declared to Customs >< Import Values declared on VAT. This includes possible customs undervaluation of M .2 B) | 7.8 |
| Sales on VAT return vs Sales on Income Tax return | 6.4 |
| Purchases on VAT Return vs Purchases on Income Tax return | 2 |
| Net profit/loss on Income Tax return vs Average Profit/loss for sector (ISIC issue) | 1.2 |
| Sales Suppression Suspected (imports + local purchases vs VAT sales) | .9 |
| PAYE return remuneration vs CIT remuneration | .9 |
| VAT paid at Customs > < VAT claimed on VAT return | .4 |
| Total import | 19.6 |
| **Risk Category – Largest Exporters 2017-18** | **M Billions** |
| Free on Board (FOB) >< VAT Zero rated sales | 1.3 |
| CIT export sales >< FOB | * |
| CIT export Sales >< VAT Zero rated sales | * |
| Total export | 1.3 |
| **GRAND TOTAL at risk** | **20.9** |

*No data as export sales not recorded on the CIT return.

## Table 2. Major Company Findings in Order of Priority (2017-18)

| Risk categories (in priority order) | No of major companies at risk | At risk (%) | Comments |
|---|---|---|---|
| Non-filer/irregular filer/nil filer/not-registered/ should register. | 16 | 17 | Top priority. Quick Revenue areas. |
| Major discrepancy in the value of imports declared to Customs and VAT. | 84 | 89 | High risk area. Need for public education and enforcement. |
| Major discrepancy in the Gross Sales amounts declared to Income Tax and VAT. | 31 | 33 | High priority. Need for public education and enforcement. |
| Major discrepancy in the Purchases amounts declared to Income Tax and VAT. | 17 | 18 | High risk priority area. Need for public education and enforcement. |
| Net profits declared less than average profits for the sector. | 51 | 54 | High risk area. |
| Sales declared on VAT return < imports and domestic purchases. | 9 | 9 | High priority. Need for public education and enforcement. |
| PAYE remuneration vs CIT remuneration. | 37 | 39 | High risk area. |
| Major difference in VAT paid at Customs vs claimed on VAT return. | 48 | 51 | High risk area. Need for public education and enforcement. |
| Risky VAT input/output ratio. | 66 | 70 | High risk net credit position. |
| Suspicious Net Profit/Gross Sales. | 49 | 52 | High risk area. |
| Possible customs undervaluation. | 8 | 9 | High risk area. |
| ID issues. | 1 | 1 | Top priority. |
| **<u>Export - Risk</u> categories (in priority order)** | **No of major companies at risk** | **% at risk** | **Comments** |
| FOB>< VAT Zero rated sales. | 12 | 52 | Major risk. |
| Suspicious ratio domestic sales/FOB. | 2 | 8 | Possible risk, depending on the nature of the company. |
| CIF/FOB ratio. | 5 | 22 | Possible risk, depending on the nature of the company. |
| CIT export sales><FOB. | * | * | Major risk. |
| CIT export Sales><VAT Zero rated sales. | * | * | Major risk. |
| Non-Filers/Nil Filer for Exports. | 2 | 8 | Major risk. |
| ID issue. | 1 | 4 | Top priority. |

*No data as export sales not reported on the CIT return.

11. **In addition to the major findings highlighted, the team also identified key systemic risks within LRA that render the organization potentially vulnerable to revenue loss.** Prominent among those risks are the following:

- **management and staff awareness regarding the importance of data should be enhanced.** The management and control of VAT and IT returns and data input should be improved to avoid compromising downstream enforcement activity and data analysis. Incomplete returns should be rejected. Data input from these returns must be subjected to enhanced quality control review by management.

- **guidelines for completion of VAT and IT returns are inadequate to promote voluntary compliance.** Existing guidelines are far too vague and general. Precision is required with definitions and step-by-step instructions. Consultation with the private sector is advisable in addressing this issue effectively.

- **there is a lack of key enforcement data to effectively analyze compliance in VAT and CIT programs.** This should be addressed by requiring more precise information in key areas on tax returns as outlined in Table 3 below:

**Table 3. Changes Required on Tax Returns to Improve Compliance**

| Return | Change required | Remarks |
|---|---|---|
| VAT | Separate goods and services in section 8(a) and (b) – value of imports. | Allows better comparison with Customs data for "value of imports" – a proven high non-compliance area. |
| VAT | Separate goods and services in section 7-local purchases. | Allows better comparison with CIT & IIT purchases – a proven high non-compliance area. |
| VAT | Separate local and zero-rated sales in sect 4 – zero rated sales. | Allows better comparison with customs FOB exports. |
| CIT | Require data on the "value of exports." | Allows comparison with Customs data for value of exports, and with VAT Zero- rated sales, – all proven high non-compliance areas. |
| CIT | Require "International Standard Industrial Codes (ISIC)." | Lack of the codes diminishes the ability to analyze the appropriateness of stated profit/loss declarations by comparing them to sector norms. |
| CIT | Disaggregate "Expenses in all its categories. (e.g. local and import purchases). | Allows comparison with VAT purchases and customs imports. |
| PAYE | Add a section requiring salaries and wages below PAYE threshold. | Allow better comparison with CIT /IIT return and PAYE returns. |

- **LRA needs to amend the ETPM to input the CIT returns with "substituted accounting period."**

- **LRA should focus more on the risk of 'diversion' of exported goods.** Control and monitoring needs improvement in customs as the prevailing understanding is that they are low risk for revenue purposes because there are no export duties. There is little understanding of the downstream revenue vulnerability of 'false' exports (valuation and/or physical count) on the following programs: Customs – drawback, inward processing, and temporary entry; VAT – credits; CIT – profit suppression. Customs currently performs limited valuation verification or physical verification of exports. Experience has demonstrated that all these areas are extreme risks for diversion into the market in developing countries due to the lack of monitoring.

- **Customs should seek TA to perform an exemption/concession review to strengthen downstream enforcement in this high-risk area.** Experience has demonstrated leakage is usually extreme in this area. In the meantime, the PCA unit should perform "show me" audits of major mines to determine if expensive heavy equipment is still on site, legally exported or sold, or diverted into the domestic market illegally.

- **LRA is underutilizing many customs and various other government business license 'power levers' to compel compliance with VAT and CIT laws.** The following privileges/licenses/special services are heavily used/needed by importers in the customs regime: exemptions, export promotion schemes, bonded warehouse licenses, agent licenses, and the Preferred Trader program. Each is a valued benefit that can be revoked for cause, including non-compliance with the laws of Lesotho, which would include non-payment of taxes due (debts). Inclusion of tax paying obligations in all license/privilege agreements would solidify the legal/moral basis of such action. After fully utilizing all LRA levers to compel compliance, the same approach could be expanded to licenses issued by other government departments.[1]

- **The existing Tax Clearance Certificate (TCC) program needs strengthening to compel tax compliance and payment of debts.** While the TCC exists in Lesotho and is enforced for government procurement, it is not enforced at the border. Unlike most countries using a TCC, customs does not hold goods or seize goods when the importer lacks a TCC. The LRA should consider implementing a "Hold/Seize Order" to customs for serious non-compliance and non-payment of debt. Since most large taxpayers are also importers this would have a positive impact on reducing non-compliance. A legal review would be required to ensure the LRA has the power to issues such orders. The TCC can remain for government procurement and any other purposes

[1] This may require legislation.

- **LRA lacks adequate analytics capacity and would benefit from additional advanced excel/access, analytics, and data extraction training.** LRA should seek donor support in the delivery of excel, access, and analytics advanced training.

- **LRA should adopt a "focused audit" approach for companies with specific anomalies identified by the DM.** The traditional "comprehensive audit" approach, which takes much more time per auditor, would continue for other audits in the audit plan. This would facilitate quicker revenue generation of the "low hanging fruit" detected by the DM. Further, audit is not the only tactic available for follow-up as assessments and investigations are equally applicable as required.

- **LRA should enhance monitoring and control of "deferred accounts" to ensure all import VAT is paid.**

# III. RECOMMENDATIONS AND AGREED NEXT STEPS

**12. Activities to address the key capacity gaps were discussed and agreed.** The LRA agreed to undertake the DM 25-point action plan to address the identified potential compliance risks in a prudent and appropriate manner. A summary of key recommendations is shown at Table 4. The CG expressed an interest in additional TA in the following areas; (i) advanced excel/access application data analysis, analytics, and data extraction training; (ii) development of a risk-based compliance management strategy; and (iii) a review of customs exemptions and concessions.

**Table 4. Action Plan**

| Ref: | Activities | Timescale |
|---|---|---|
| 1. | Arrange a seminar between the IT responsible for Applications Development and Business and Process Management with the Compliance Risk Management Department to improve communications regarding data extraction. | February 20 |
| 2. | Implement the proposed "Hold/Seize Order" to customs to compel tax compliance and debt payment. | April 20 |
| 3. | Enhance monitoring and control of "deferred accounts" to ensure all import VAT is paid. | April 20 |
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| 11. | Implement procedures to leverage all customs privileges/licenses/special services arrangements to compel tax compliance and payment of debt. | December 20 |
| 12. | Complete an annual DM exercise. | December 20 |
| 13. | Complete and evaluate the implementation of the DM action plan. | December 21 |

# Appendix I. Results-Base Management Framework

| Lesotho (LSO) | | |
|---|---|---|
| **Objective: Improved customs administration core functions** | | |
| **Outcome** | **Verifiable Indicators** | **Comments** |
| Customs control during the clearance process more effectively ensures accuracy of declarations. | 1. Risk Based control selectivity applied more consistently.<br><br>2. Rate of physical inspections decreased. | 1. The LRA has a detailed risk profile for every major importer and exporter and priorities for audit plans based on risk.<br>2. Yet to be evaluated. |
| **Milestones** | **Target Completion Date** | **Comments** |
| Customs and Tax are able to conduct data matching analyses to identify risk. | February 28, 2020 | **Status: Fully achieved** - The LRA team can apply the standard DM methods, steps, and procedures. The LRA is now capable of performing future data matches on its own without any additional TA support. |
| Data matching used to reduce front end inspections and increased post clearance audit activity. | February 28, 2021 | **Status: Partially achieved** - The LRA now has a detailed risk profile for every major importer and exporter and priorities for audit plans based on risk. This is a major enabler to make collateral reductions in non-productive front-end inspections. |