

AUDIT REPORT

Riga

December 27, 2007

No.5.1-2-5/2007

On Administration of Reduced Rates of Value Added Tax

Legal Justification of the Audit

1. The legality audit on administration of reduced rates (relief) of value added tax (hereinafter – VAT) was conducted according to the Section 2 of the Law on the State Audit Office and audit assignment of the State Audit Office 1st Audit Department No. 5.1-2-5/2007 of March 5, 2007.
2. The audit was conducted by Senior State Auditors Īva Šaicāne, Iveta Martuzāne, Liene Upeniece (until September 3, 2007), Sandijs Māliņš (until September 3, 2007), State Auditor Ilze Ozola and State Auditor - Lawyer Oskars Erdmanis.

Audit Objective

3. The objective of the audit is to gain assurance that the State Revenue Service provides administration of reduced VAT rates:
 - 3.1. To verify if control over justified application of reduced VAT rates is provided and organized;
 - 3.2. To verify if revenue from reduced VAT rates is accounted and if forgone tax revenue, resulting from application of reduced rate, which could possibly be received if full VAT rate had been applied, is calculated.
4. To clarify if the Ministry of Finance provides development and implementation of tax policy regarding reduced VAT rates and if reduced tax rate's efficiency and benefit to the public is assessed.

Accountability of the State Audit Office Auditors

5. Auditors of the State Audit Office are responsible for the audit report, which is based on the audit evidence obtained in the audit.

Accountability of the Audited Entity

6. The Ministry of Finance and the State Revenue Service are responsible for compliance with the regulatory enactments and truthfulness of the information provided to the auditors.

Scope of the Audit

7. The audit is conducted in accordance with international auditing standards recognized in the Republic of Latvia. The audit was planned and performed to obtain reasonable

assurance on compliance of administration of reduced VAT 5% rates and VAT 12% compensations paid to agricultural produce manufacturers with the requirements of regulatory enactments.

8. The audit was conducted within the framework of integrated parallel audit (hereinafter – parallel audit) of EUROSAI 3rd sub-group¹ on tax relief (including on reduced VAT rates). The objective of the parallel audit is to examine tax relief – reduced VAT rate. The scope of the audit and audited issues are adapted to the objectives and audited issues of the parallel audit.
9. In accordance with the manual² published by International Monetary Fund the reduced tax rates are considered as tax expenditures (relief). In accordance with OECD³ guidelines⁴ tax rate relief is considered as one of tax relief types – a reduced rate of tax applied to a class of tax payers or taxable transactions.
10. Within the framework of the audit:
 - 10.1. Interviews regarding reduced VAT rate administration system were conducted at the Ministry of Finance, the State Revenue Service, the Health Statistics and Medical Technologies State Agency and the State Agency of Medicines;
 - 10.2. Inspections were carried out on administration of VAT rates in 2005 and 2006, including:
 - 10.2.1. Compliance of activity of the Ministry of Finance (development and implementation of tax policy, development of draft legal enactments, budget revenue forecast, supervision in the tax field) regarding introduction and supervision of reduced VAT rates, with the regulatory enactments;
 - 10.2.2. Compliance of activity of the State Revenue Service (activities performed by the State Revenue Service providing accounting and control of reduced VAT rate and rendering consultations to tax payers on application of reduced VAT rate, activities performed by the State Revenue Service providing justified application of reduced VAT rate, activities performed by the State Revenue Service providing administration of compensations paid to agricultural produce manufacturers) regarding introduction and supervision of reduced VAT rates, with the regulatory enactments;
 - 10.3. Information was acquired regarding activities of institutions involved with administration of reduced VAT rates:
 - 10.3.1. Activities of the Health Statistics and Medical Technologies State Agency maintaining register of medical goods and medical devices, to which reduced VAT rate is applied;

¹ EUROSAI (European Organisation of Supreme Audit Institutions where the State Audit Office of the Republic of Latvia is a member) 3rd sub-group has been established to perform integrated parallel audit “On Administration of Reduced Rates (relief) of Value Added Tax”.

² International Monetary Fund manual „Manual on Fiscal Transparency”, 2007, www.imf.org

³ Organization for Economic Co-operation and Development.

⁴ OECD guidelines “Best practice guidelines – off-budget and tax expenditures”, 2004

- 10.3.2. Activities of the State Agency of Medicines, maintaining and updating the Drug Register of the Republic of Latvia on medicinal products and veterinary medicinal products, which reduced VAT rate is applied;
- 10.3.3. Activities of the Ministry of Health regarding legislation development process regulating VAT 5% rate applicable to medical goods and medicinal products, as well as regarding analysis of reduced VAT rates introduction impact on consumption of medicinal products and medical devices and on alteration of prices;
- 10.3.4. Activities of the State Pharmaceutical Inspection regarding medicinal products market supervision;
- 10.3.5. Data regarding impact of reduced VAT rate on State economical processes available from the Central Statistical Bureau.
- 10.4. Tax payer survey was conducted in order to obtain information on expediency of reduced VAT rates and assess if reduced rates reach the target audience. Tax payers, who, supply goods and render services that are applied reduced VAT rate, were selected at random for the survey.
- 11. The audit provided sufficient and according audit evidence for drawing up the audit report.

Summary

- 12. The following discrepancies were disclosed in the activity of the Ministry of Finance, providing development and implementation and of tax policy, and in the activity of the State Revenue Service, providing administration of reduced VAT rate:
 - 12.1. Although the Ministry of Finance is responsible for development of fiscal policy and State budget, the Ministry has not established performance indicators targeted at achievement of certain goals and unified their achievement supervision mechanism in the regulatory enactments regarding reduced VAT rates. Thus the benefit of the public from implementation of reduced VAT rates policy is not assessed;
 - 12.2. As the regulatory enactments do not stipulate that reduced VAT rate is considered as tax rebate or relief, information on possibly receivable VAT amounts, that are not received as a result of introduction of reduced rates, is not aggregated and the Ministry of Finance does not submit this information to the Cabinet of Ministers as it submits information on the amount of taxes forgone, which has occurred as a result of the application of tax relief in accordance with regulatory enactment⁵;
 - 12.3. The audit disclosed discrepancies of the regulatory enactment of the Republic of Latvia⁶ with Council Directive⁷. Tax payers in Latvia are granted rights to apply reduced VAT rates to a broader range of goods than the Council Directive allows;

⁵ Section 31 of the Law „On Budget and Financial Management”.

⁶ Section 6², Clause 2 of the Law “On Value Added Tax”.

⁷ Council Directive 77/388/EEC on the harmonization of the laws of the Member States relating to turnover taxes – Common system of value-added tax: uniform basis of assessment (valid until 31 December 2006) and Council Directive 2006/112/EC on the common system of value added tax (in force from 1 January 2007).

12.4. Discrepancies were detected in the internal control system of the State Revenue Service, providing administration of reduced VAT rates and VAT 12% compensations paid to agricultural produce manufacturers:

12.4.1. Exact steps how to examine and document justification of VAT 12% compensation payments are not specified in the methodology developed by the State Revenue Service, thus adequate implementation of requirements specified by regulatory enactment⁸ is not provided;

12.4.2. Although the regulatory enactment⁹ specifies the criteria for receipt of VAT 12% compensations, the audit disclosed certain case, when the State Revenue Service does not verify if compensation recipient has registered the farm or submitted confirmation of local government regarding land ownership rights or right to use the land in accordance with the requirements of regulatory enactment¹⁰.

12.4.3. During the audit, institution, indirectly involved with administration of reduced VAT rates, provided information on disclosed occasions, when reduced VAT rate is applied to medical devices, which do not comply with the criteria of medical device status, thus the reduced rate shall not be applied. As the State Revenue Service and institutions, indirectly involved with administration of reduced VAT rates, do not have sufficient cooperation and information exchange on occasions, when reduced VAT rate was applied without justification, the audit did not obtain assurance that the State Revenue Service is able to provide sufficient control of justified application of reduced VAT rate.

⁸ Section 13¹, Paragraphs eight and nine of the Law “On Value Added Tax”.

⁹ Section 13¹, Paragraph five of the Law “On Value Added Tax”.

¹⁰ Section 13¹, Paragraph five of the Law “On Value Added Tax”.