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Israel Tax Authority

Aspects of Effectiveness of the Tax System

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Background

The tax system is intended to collect taxes from the country's residents to finance public services such as security, physical infrastructures, health, education, and welfare. According to the State of Israel's financial statements for 2020, the state revenues from taxes and fees this year were about NIS 389 billion, (about 79% of the state revenues for this year, about NIS 492 billion). Hence, the importance of the Israel Tax Authority (the Authority) is the tax collection enforcement from all sectors of the economy and initiating tax regulation according to economic developments, etc.

Key Figures

NIS 362 billion

state revenues from direct and indirect taxes (gross) in 2020

NIS 11 billion

the total cumulative expenditure by the tax authority in 2017–2020

NIS 67 billion

estimated tax benefits in 2019, which increased by 34% in 2015–2019

about NIS 18 billion

the additional tax in 2019 from income tax and VAT assessments, 11.5% of the total income tax and VAT this year (NIS 156 billion) compared to total tax collection of NIS 310 billion

1.185 million reports

were submitted by self-employed persons, companies, employees, and public institutions obligated to report to the Tax Authority in 2020, compared to about 692,000 reports in 2012 (an increase of about 71%)

97% of the closed tax assessments

by the Tax Authority based on a taxpayer's declaration (45%) and assessments in agreement (52%) as of 2019

26 tax cases

in the scope of NIS 24.4 billion are pending in legal tribunals as of June 2021

700 investigation cases

(About 40%) out of 1,800 investigation cases awaited 3 years or more for legal hearings as of January 2019

843 applications for "ransom"

were submitted to the Tax Authority by taxpayers and self-employed who evaded taxes in 2016–2018

NIS 96 billion

the "tax gap" estimate – the Value Added Tax that the Tax Authority did not collect in 2008–2019

NIS 998 million

the taxes paid by 168 diamond dealers according to voluntary disclosure agreements in 2017–2019

23,070 citizens

(12%) out of the 197,314 did not respond to the Authority's letters as part of a campaign to expand the reporting network in 2014–2021

Audit Actions

From May 2021 to January 2022, the State Comptroller's Office examined the efficiency and effectiveness of the tax system. The audit was conducted at the Tax Authority. A supplementary audit was conducted in the Ministry of Finance, the Chief Economist's Division, the Ministry of Justice, and the Courts Administration.

Key Findings

The Complexity of the Tax System and of the Tax System's Performance Measurement

The Complexity of the Tax System – the tax system in Israel is complex and includes comprehensive legislation[1], and over the years, many amendments have been made thereto. Moreover, many regulations were promulgated to implement these laws. In addition, the Tax Authority publishes guidelines and circulars to its taxpayers and even makes individual taxation decisions. Due to these and other countries tax laws affecting Israel's taxation, there is also some ambiguity in matters previously regulated by law. It was found that there is no government body to carry out systematic staff work in preparation for the enactment of tax reforms to examine the reform effects on the complicated tax system, on the taxpayer compliance costs, on the computing adjustments costs, and the administrative preparation the reform requires (for example, preparation of additional forms and their computerization). Moreover, the tax laws did not undergo organization, collation, and simplification and were not adapted to the current situation (codification), despite the following: (a) the extensive changes made in the tax law reforms in recent years; (b) the complexity of the tax laws; (c) the multiple preliminary decisions, directives, and circulars; (d) the changes in the tax laws of other countries affecting the tax laws in Israel; (e) the ambiguity of previous legislation, case law, and the Authority's position.

The Effectiveness Level of the Tax Systems in Israel in an International Comparison – by the Tax Foundation Organization[2] from October 2021, ranking the competitiveness level of the tax systems in the 37 OECD member states, in the State of Israel, there was the most significant improvement in this ranking compared to the previous ranking published in 2020 (from 27th to the 14th). Moreover, Israel is ranked 17th in terms of corporate tax, 12th place in terms of VAT, and 10th place in terms of land taxes and customs. However, it was found that Israel is in 29th place in terms of the individual's tax, and its tax system has vulnerabilities compared to other countries, manifested in filling out annual reporting forms for companies, in the Israel tax brackets system, and in the relatively small number of bilateral tax treaties Israel signed with reciprocating states.

It was further raised that in some indicators, the Tax Authority is ranked lower than the tax authorities in the OECD member states, affecting its efficiency in collecting taxes. For

1 The Income Tax Ordinance, the VAT Law, the Purchase Tax Law, The Customs Ordinance and more.

2 An international body conducting studies in collaboration with OECD representatives.

example: (a) A low rate of the Authority's employees handles large businesses – ranking 29 out of 38 OECD states; (b) A low rate of the Authority's employees is assigned to auditing or collection and enforcement of tax obligations – ranking 23; (c) A high rate of the Authority's costs concerning its tax collection – ranking 29. On the other hand, it was raised that some indicators were ranked relatively high compared to the OECD states. For example, according to the data for 2016–2017, the authority was ranked fifth in the number of audits it performs on every 100 active companies.

Measuring the Performance of the Tax Authority and Publishing it – the state's total revenue from direct and indirect taxes in 2019 was estimated at about NIS 310 billion. Of this income, the total tax collected was about NIS 55 billion, and the total VAT collected was about NIS 101 billion. The tax yield of the income tax assessment offices was about NIS 13 billion, about 24% of the income tax collected (without deductions and land taxes). The tax yield of the VAT offices was about NIS 4.9 billion, about 5% of the VAT collected. As a result, the tax increase in 2019 from income tax and VAT assessments was about NIS 18 billion, 11.5% of the total collection of income tax and VAT this year (NIS 156 billion), and this vis-a-vis a total collection from all tax assessments at NIS 310 billion.

It was raised that the Ministry of Finance in Israel publishes only the tax collection scope and the degree of compliance with tax forecasts, with no data on the Authority's work vis-à-vis the taxpayer. However, these data do not necessarily reflect the tax system's efficiency since 88.5% of the income tax and VAT collection is automatic by withholding, without the Tax Authority's involvement, and is mainly affected by macroeconomic data. It should be noted that the US Tax Authority examines its work and even publishes its examinations to the general public and decision-makers.

The Tax Assessment in Israel Compared to Other Countries – by the OECD comparison report (2021) between the tax authorities in 59 countries, the number of employees in the Tax Authority in Israel is high relative to the number of working-age residents (the working age population) compared to the average and median in the other countries surveyed. Thus, for example, in 2019, there was one authority employee for every 622 working-age residents, while in the other countries surveyed, the average was – one employee for every 1,652 residents, and the median was one employee for every 728 residents. Furthermore, between 2018 and 2019, their rate increased in Israel, while in the surveyed countries (the average and median), the number of tax authority employees for each working-age resident went down.

It was also raised that vis-a-vis the surveyed countries, the Israel Tax Authority allocates fewer inputs and means to the core activity – assessments, audits, and enforcement, compared to the surveyed countries. Thus, in 2019, the rate of employees assigned to enforcing tax collection operations was lower than the internationally accepted rates (7% in Israel compared to 12% on average). In addition, a lower rate of the Authority's employees is assigned to audits in large businesses (in 2019 – 1.2% of all the Authority's employees against an average of 4.5% in the 50 countries surveyed).

Promoting National Goals Through the Granting of Tax Benefits – the state budget in recent years includes tax benefits of tens of billions of NIS. For example, in 2019, the benefits were about NIS 67 billion (such as benefits for pension savings and education funds, benefits under the Encouragement of Capital Investments Law, tax benefits on income from gambling, etc.), but no retrospective examination was conducted to verify if the various benefits were given to the population groups the legislator intended to, and if they fulfilled the goals set by the government. Many years ago, most of these tax benefits were added to the tax laws. Since then, no in-depth examination of their effectiveness in general and concerning other alternatives has been carried out.

The Scope of the "Black" Economy – alongside the legal economy that is reported to the tax authorities and the various authorities, there is an economy that is not reported, known as the "black economy." One of its main goals is to avoid paying taxes. By the International Monetary Fund report from 2018, the estimated average rate of the "black economy" in Israel in 1991–2015 was 22% of GDP. It was raised that the Tax Authority and the enforcement bodies do not routinely publish activity estimates in the various illegal economic sectors. Therefore, it is impossible to analyze the effectiveness of the collaboration scopes between the tax authorities and the other enforcement bodies in each black economy hub.

The Efficacy of the Tax Authority's Activity

The Location of the Regional Assessment Offices – in 2019, the income tax assessment offices examined about 17 thousand tax files of self-employed persons, companies, managers, and employees. There is a gap between the physical location of the offices, almost all established decades ago, and between the commercial and industrial areas that were developed in the country since then, especially in the country's center. About two-thirds of the assessment files examined are concentrated in 12 specific assessment offices (mainly in the central region) out of 26 (including the integrated office).

The Results of the Examination of Income Tax Report Assessments – in 2019, the Tax Authority assessment offices collected about NIS 15.1 billion, mostly from assessments according to the taxpayer's declaration or assessments in an agreement between the Authority and the taxpayer. It was found that the Tax Authority could not pinpoint the tax decrease or the tax additions in the various assessment stages for the same taxpayer since the Authority's data of each final assessment includes only the last assessment stage. For example, it is impossible to compare an assessment issued after an appeal was filed to the court as a tax agreement between the Authority and the taxpayer, with the tax in the final assessment and the tax determined with respect thereto in each of the previous assessment stages.

Development of Separate Models for an Informed Selection of Cases for Assessment – the primary key to optimize the assessment procedures is an informed selection of cases to handle in an assessment and the handling methods and the types of examinations required. This highlights the need to improve the quality of the Authority's data mining system. It was raised that the Authority did not formulate separate models for handling taxpayers according to their size, fields of activity, and characteristics to maximize the tax yield alongside strengthening the Authority's control and deterrence of all businesses in the economy.

The Assessment Offices' Handling of Headquarter and Field Files – by the Authority's guidelines, "headquarter files" should constitute 20% of all the files handled by the offices. It was raised that the Tax Authority does not have data on the headquarter files dealt with in the assessment offices. It has no information on the extent to which the headquarter files met the objectives, the tax yield in the headquarter files vis-a-vis the field files, etc. It was also raised that the Authority has no data on the field files included in the work plan that were not handled.

The Reward Model in VAT Offices and Income Tax Offices to Optimize the Assessment Procedures – a summary report of an organizational review prepared by an external consulting company included, among other things, recommendations for change in assessment and audit processes among income tax inspectors and auditors of accounts in the VAT offices. Following the report, it was decided to launch a preliminary study (pilot) in which the tax inspectors and auditors will gradually be introduced to professional activity according to the outline. During the pilot period, the construction of an updated compensation and incentive model began, including the conclusions of the consulting company and implementing the Authority's goals concerning professional activity through results and quality indicators. It was raised that from January 2016 to January 2020, for 4 years, the Tel Aviv office (number 5) employees received a maximum and fixed incentive pay (without measurement) at the rate of 25%. From September 2016 to January 2020, for over three years, the employees of the offices in Kfar Saba, Ramla, and Jerusalem (number 2) received a maximum and fixed incentive pay (without measurement) of 25%. In addition, the employees in the VAT offices who were added to the pilot according to the new method of reward model received from the date of their addition to the pilot until December 2021 a fixed premium at a maximum rate not related to the Authority management's goals and the results of their work.

It was further raised that a new reward model has not yet been determined and implemented in the Tel Aviv Large Enterprises Appraisal Office and the Haifa and Jerusalem Large Enterprises Appraisal Units, which are central to the financial scope of the cases managed, the tax yield generated therefrom, and as of June 2022, these offices operate according to the old incentive pay model.

Administrative and Legal Procedures in Tax Cases

Delay in Processing Tax Orders – as of June 2021, 2,108 tax orders are being heard in legal tribunals, where the disputed income tax in civil legal proceedings was about NIS 28.1 billion, of which 26 tax cases are in cumulative tax of about NIS 24.4 billion, including NIS 6.9 billion of nine orders that were issued to a large company in Israel. It was raised that the Tax Authority does not have centralized data on the topics above, enabling it to monitor and control the process of the civil proceedings. For example, the orders issuing dates, the average duration of cases handled in each district court, and the number of cases in which there was an additional delay due to an additional appeal by the taxpayer to the Supreme Court. It was also raised that, as of the audit completion date, the Courts Administration added no positions for designated judges in tax cases in the Tel Aviv Magistrate's Court. A designated judge was added to the Central District Magistrate's Court, and accordingly, the concentration of tax cases with these judges has increased. A delay in processing tax orders of tens of billions of NIS over many years harms the state treasury and the Tax Authority's deterrence capability. It may even harm the ability to enforce court rulings – particularly when a taxable company terminate its activities over the years.

Cases Awaiting a Decision by the Legal Bureau of the Tax Authority – it was raised that, contrary to the Attorney General's directive to the government from 2010 to complete the processing of cases in periods of up to 24 months, depending on the seriousness of the offense, as of January 2019 about 700 cases out of 1,800 have been waiting for over three years.

The Reasoning and Publication of the "Ransom" Procedure – the ransom procedure is an alternative procedure to criminal law, which enables suspects in tax offenses to avoid a criminal procedure and the expected punishment upon its conclusion, by the payment of money. In 2016–2018, 843 taxpayers and self-employed submitted applications for ransom (746 applications were approved). The Tax Authority denied 97 applications, and in 55 of the cases, indictments were filed against the tax offenders, and 21 cases were closed due to lack of evidence. It was raised that the Authority does not publish detailed reasoning for the approved ransom arrangements, but a few short lines without a detailed explanation. It was also raised that there is a delay of about two years in publishing the decisions of the ransom committees. For example, the 2017 ransom committee collection of decisions was only published in November 2019; The ransom committee collection of decisions for 2018 was only published in March 2021. An examination of ten tax cases where ransom committee decisions were adopted raised that in five of them, the committee's published considerations were partial and did not include all of its deliberations. The publication did not match the committee's concerns in two other cases. Moreover, an examination of 50 publications of the ransom committees' decisions in 2018 raised that in 37 cases, the rate of the ransom for transaction tax evasion offenses or illegal deduction of input tax offenses was between 20% and 30% of the offense sum, however, from the committee's reasoning, it was impossible to understand why in some cases different rates were set within and outside this range. It was also found that the notice sent by the Authority to the applicant about the denial of his application was not reasoned.

Operational Aspects of the Authority's Activity

Computerized Assessment Audit File – in 2015, the recommendations of an internal committee at the Authority, appointed to formulate an outline for developing a computerized audit file, were submitted. It was raised that the taxpayers' files were managed manually at the audit completion. The development of a computerized income tax audit file system began on January 1, 2019. As of January 2022, the development of about 64% of the project has been completed, and its completion date has been postponed to June 2023.

Online Capital Declarations – a capital declaration may serve the tax inspector as a critical control tool to select files for the work plan and for the assessment process. The examination is done by comparing capital declarations submitted several years apart, from which it is possible to learn whether the taxpayer's capital has increased reasonably, consistent with the reports he submitted in the annual tax returns. It was raised that the capital declarations examination procedure was done manually and that the "online declaration of capital" characterization document was prepared in 2015 but was not completed. It was also raised that the development of the system was included in the work plan of the Assessment Division and the Computerized Processing Service (Shaam) in 2016 but was not implemented over the years.

Tax Collection in the Various Tax Departments – it was raised that although all tax departments operate under the same legislative authority – the Taxes (Collection) Ordinance – the Tax Authority conducts an independent collection process for each of the tax systems: income tax, deductions, VAT, land taxation and customs, and that the taxpayer may receive several payment booklets at the same time: a booklet for income tax advances, a booklet for income tax deductions and a VAT booklet. It was also raised that the collection processes and payment arrangements in the various tax departments are made separately vis-à-vis the multiple offices.

Merging the Regional Tax Offices to Improve Service and Tax Collection – at the audit completion, about 20 years after the government decides on the merger of the activities of the "Customs and VAT Division, the Income Tax Commission [Division], and the Computerized Processing Service (Shaam)," the merger of the regional offices and the vision of "One Point of Service" is still far from being realized, and is different from what is customary in tax authorities in leading countries in the world. The departments merged into one authority continue to operate separately in most operational aspects. No benefit is derived from the merger, neither in operational aspects nor in improving tax collection or service to the taxpayer and reducing the bureaucratic burden imposed on him due to duplicate procedures vis-à-vis the various tax systems. In addition, the Tax Authority is currently not pursuing further merging of the tax departments.

An Increase in the Number of those Obligated to Report Compared to a Decrease in the Number of Income Tax Inspectors and to Their Contribution to the Total Tax Collection – it was raised that there was a constant increase (approximately 71%) in the number of those obligated to submit reports (excluding employees who are not obligated to report and submitted reports for tax refunds) from 691,827 in 2012 to 1,185,349 in 2020. For example, there was an increase of about 130% among the employees, 75.5% among self-employed, and 44.3% among companies. On the other hand, the number of income tax inspectors decreased by about 20.6% in 2012–2020, despite an increase of about 71% in the number of those obliged to report and despite the need to handle hundreds of thousands of tax refund reports. It was also found that as of 2020, 825,000 (about 70%) of the reports required to be submitted to the Tax Authority are from self-employed, constituting 6% of the total collection of direct and indirect taxes in the said year.

Expanding the Reporting Network Among Tax Evaders – the Authority collected taxes at NIS 4.94 billion following campaigns to expand the reporting network in 2014–2021.

Dealing with Severe Crimes and Fictitious Tax Invoices – value-added tax is the main component in collecting indirect taxes. Its total net collection (minus VAT refunds) in 2018–2019 was about NIS 199 billion. The total return of the VAT offices for the assessment work was about NIS 9.24 billion. In these years, the assessment charges, at NIS 4.76 billion, from the handling results of severe crime cases comprised of the distribution of fictitious tax invoices and the use thereof.

Key Recommendations

- To fundamentally change the current situation, where tax laws are becoming increasingly complicated over the years, it is recommended to consider changing the formulation of the tax rules and base them on short, unambiguous, and easy-to-implement principles reducing the need to publish supplementary administrative instructions.

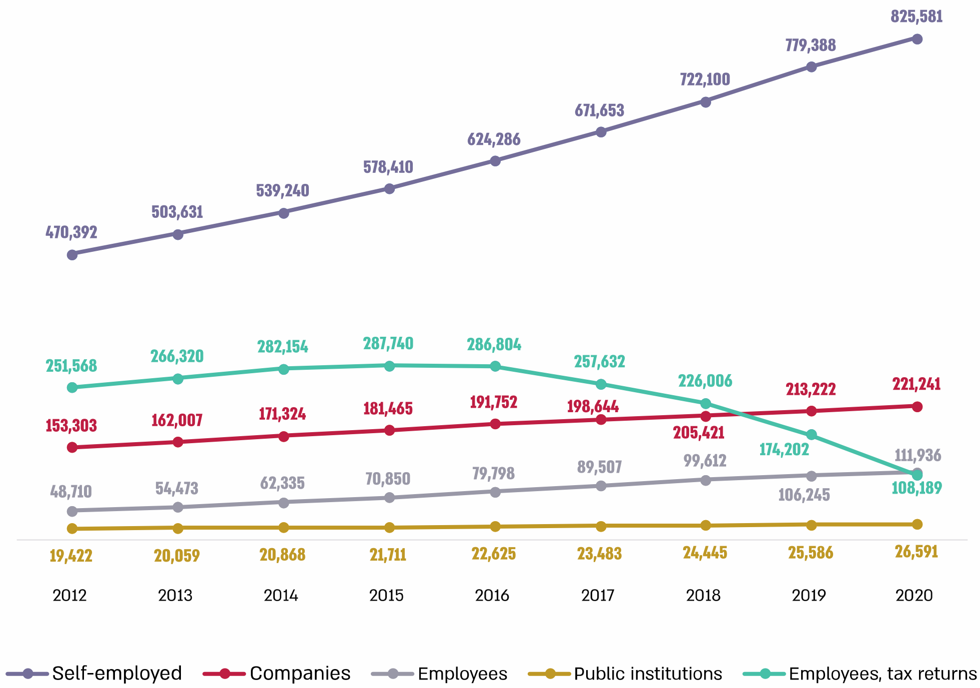
- It is recommended that the Authority complete the "Digitization Declaration of Capital" project and implement it. It is also recommended to expand the assessment corrections model based on technological tools. In addition, it is recommended that the Authority initiate strategic work to examine the benefits inherent in consolidating the collection activity: streamlining the system and unifying the treatment, as well as saving on bureaucracy and the administrative burden imposed on taxpayers.

- It is recommended that the Courts Administration consider to concentrate efforts and prioritize 26 tax cases in which the disputed tax excessed is NIS 100 million and the cumulative tax pending in the courts is about NIS 24.4 billion.

- It is recommended that the Authority carry out strategic work and prepare a multi-year plan to implement the government's resolution goals concerning the consolidation of the tax departments, to improve its operation and the service to the taxpayer, and raise the level of tax collection.

- It is recommended that the Tax Authority examine the supervisory resources at its disposal and their effectiveness for tax collection in Israel relative to the increase in the various sectors reports. It is further recommended to examine the extent and simplification of the different sectors reports, such as the self-employed whose contribution to the total tax collection is low, and how to simplify these reports.

Trends in the Requirement to Submit Reports According to Different Case Types in 2012–2020



Source: The Tax Authority.

Summary

The efficacy and effectiveness of the tax system are determined by its objectives: a collection of true tax, proper enforcement; promoting public service and reducing bureaucracy; preventing tax discrimination; promoting social policy goals, and more. Deficiencies in the tax system directly affect the public.

The State Comptroller's Office examined the tax system effectiveness in Israel, including its complexity and its performance measurement, its operations efficacy, its administrative and legal procedures handling tax cases and the operational aspects at the Tax Authority. The said examination raised deficiencies, affecting the activities of the Tax Authority and its effectiveness regarding the taxpayer.

Tax laws in Israel are complex and include numerous legal provisions, regulations, and precedents. This highlights the need to base the tax rules on short, unambiguous, and easy-to-implement principles to minimize the need for supplementary administrative instructions. It is also necessary to consolidate the tax departments beyond the headquarters level; promote digitization processes, by creating a computerized audit file and abbreviated assessments for relatively small businesses; shorten tax assessments appeal procedures; and promote equitable enforcement between taxpayers.

The Ministry of Finance and the Tax Authority should rectify the audit's noted deficiencies and examine its recommendations to improve the effectiveness of the tax system in Israel.