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Presumptive Taxation of the Hard to Tax

by Victor Thuronyi[1]

This paper concerns the use of presumptive taxation methods in taxing the hard to tax, which is a subset of presumptive taxation more generally. Since other papers are concerned with the concept of the "hard to tax", I will not dwell on it, beyond noting that it is rooted in the practicalities of tax administration, and has to do with groups of taxpayers whose tax amounts are quite low compared with the administrative costs that would have to be incurred by the tax administration to assess the proper amount of tax. The term is commonly used to refer to small farmers and small businesses (self-employed persons), and I will take the concept to refer to these groups for purposes of this paper. The following factors contribute to their being hard to tax:[2]

- their number is great, making it impossible to intensively scrutinize more than a small fraction of them;
- their incomes are small, often below the poverty level;
- they are not compelled by business (i.e. nontax) reasons to keep adequate books of account;
- they sell largely to the population for cash so that application of withholding to collect their income is not practicable;
- in part due to the above factors, they can easily conceal their incomes.

I. Presumptive Methods in General

Presumptive taxation involves the use of indirect means to ascertain tax liability, which differ from the usual rules based on the taxpayer's accounts.[3] The term "presumptive" is used

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[1] Senior Counsel (Taxation), International Monetary Fund. The opinions expressed are personal to the author and do not necessarily correspond to those of the IMF. Sections of this paper are excerpted, with appropriate changes, from Victor Thuronyi, *Presumptive Taxation, in* Tax Law Design and Drafting 401 (1996).

[2] *See* Federico J. Herschel, *Taxation of Agriculture and Hard-to-Tax Groups, in* Fiscal Reform for Colombia 387, 402 (1971).

[3] A useful description is provided by Ahmad & Stern: "The term presumptive taxation covers a number of procedures under which the 'desired' base for taxation (direct or indirect) is not itself measured but is inferred from some simple indicators which are more easily measured than the base itself." Ehtisham Ahmad & Nicholas Stern, The Theory and Practice of Tax Reform in Developing Countries 276 (1991).

to indicate that there is a legal presumption that the taxpayer's income is no less than the amount resulting from application of the indirect method. As discussed below, this presumption may or may not be rebuttable. The concept covers a wide variety of alternative means of determining the tax base, ranging from methods of reconstructing income based on administrative practice, which can be rebutted by the taxpayer, to true minimum taxes with tax bases specified in legislation.[4]

Presumptive techniques may be employed for a variety of reasons.[5] One is simplification, particularly in relation to the compliance burden on taxpayers with very low turnover (and the corresponding administrative burden of auditing such taxpayers). A second is to combat tax avoidance or evasion (which works only if the indicators on which the presumption is based are more difficult to hide than those forming the basis for accounting records). Third, by providing objective indicators for tax assessment, presumptive methods may lead to a more equitable distribution of the tax burden, when normal accounts-based methods are unreliable because of problems of taxpayer compliance or administrative corruption. Fourth, rebuttable presumptions can encourage taxpayers to keep proper accounts, because they subject taxpayers to a possibly higher tax burden in the absence of such accounts. Fifth, presumptions of the exclusive type (see below) can be considered desirable because of their incentive effects—a taxpayer who earns more income will not have to pay more tax. Finally, presumptions that serve as minimum taxes may be justified by a combination of reasons (revenue need, fairness concerns, and political or technical difficulty in addressing certain problems directly as opposed to doing so through a minimum tax).

Presumptive taxation can be used for any tax that is normally based on accounting records—income tax, turnover tax, and value-added tax (VAT) or sales tax—although it is most commonly used for the income tax. A number of different types of presumptive methods exist in different countries. The discussion below first considers some general characteristics of presumptive methods — and their place in the system as a matter of overall architecture — and then discusses particular cases. It is apparent from this discussion that different types of presumptive methods can have quite different incentive effects, revenue effects, distributional consequences, levels of complexity, and legal and administrative implications. This makes it dangerous to generalize about presumptive taxation.

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[4] For further discussion and analysis of presumptive taxation, *see* Indira Rajamaran, *Presumptive Direct Taxation: Lessons from Experience in Developing Countries,* Economic and Political Weekly (forthcoming); Arye Lapidoth, The Use of Estimation for the Assessment of Taxable Business Income (1977); Kenan Bulutoglu, *Presumptive Taxation, in* Tax Policy Handbook 258 (Parthasarathi Shome ed., 1995); Russell Krelove and Janet Stotsky, *Asset and Wealth Taxes, in id.* 181; Vito Tanzi & Milka Casanegra de Jantscher, *Presumptive Income Taxation: Administrative, Efficiency, and Equity Aspects* (IMF Working Paper, 1987) (see also sources cited in these works).

[5] *See* Lapidoth, *supra* note 4, at 25.

Presumptive methods can be rebuttable or irrebuttable. Rebuttable methods include administrative approaches to reconstructing the taxpayer's income, and may or may not be specifically described in the statute. If the taxpayer disagrees with the result reached, the taxpayer can appeal by proving that his or her actual income, calculated under the normal tax accounting rules, was less than that calculated under the presumptive method.

By contrast, irrebuttable presumptive assessments should be specified in the statute or in delegated legislation. Because they are legally binding, they must be defined precisely.

Depending on the situation, irrebuttable presumptions might be subject to legal challenge as unconstitutional. In some countries, the constitutional court (or supreme court) has been quite active in applying the principle of equality in taxation. In some countries, tax law provisions that are seen as denying equal access to justice are particularly vulnerable to constitutional challenge. For example, in France, proposed amendments that would have denied to certain taxpayers the opportunity to rebut the presumption that income was no less than an amount specified on the basis of external signs of lifestyle was struck down as unconstitutional.[6] Presumptions might also be challenged on the basis that they impose tax on a basis that is inconsistent with ability to pay. In other words, if two taxpayers with the same income are taxed on an unequal basis, because one of them is presumed to have a higher amount of income due to a presumption, the principle of equality is violated unless there is sufficient justification for the difference in treatment. On the other hand, a presumption that is in the nature of a minimum tax might be seen as equally applicable to all, as constituting in itself a valid basis for taxation, and hence as constitutionally immune from challenge on equal protection grounds. The attitude of courts to presumptions will depend on the general climate for constitutional tax litigation, on past precedents in the particular jurisdiction, and on the specific features of the presumptions themselves. Therefore, general conclusions are hard to draw, other than to point out that whenever irrebuttable presumptions are considered, legal advice should be sought as to the possibility that the presumption will be challenged in court on constitutional grounds.

The *forfait* applicable in France (discussed below) is a hybrid between rebuttable and irrebuttable methods. It is rebuttable in the sense that the taxpayer may elect to use the normal accounting rules instead of the *forfait*. Under the *forfait,* the determination of income is a matter of negotiation between the taxpayer and the tax inspector. However, once it is

[6] The Court found the right to procedural due process to be violated by provisions of the 1974 finance bill. One of these involved the rules concerning deemed taxation, based on specified indicia of the taxpayer's lifestyle. The 1974 finance bill would have added a provision to the tax code allowing taxpayers to avoid an assessment on this basis by proving that the taxpayer did not have hidden sources of income. However, this procedure of proof would have been unavailable to taxpayers with income above a specified level. The Constitutional Council found that the denial of this possibility of proof to a limited group was a violation of the constitutional principle of equality before the law. Cons. const., Dec. 27, 1973, Dec. No. 51 DC, Rec. 25.

agreed on for the specified period of two years, it applies automatically regardless of the taxpayer's actual income for the period. The *forfait* can therefore be described as rebuttable *ex ante* but irrebuttable *ex post*.

Irrebuttable presumptions can be divided into two types: minimum tax, where tax liability is no less than that determined under the presumptive rules, and exclusive, where tax liability is determined under the presumption alone, even if the regular rules might lead to a higher liability. An example of the latter would be a tax on agricultural income based on the value of the land, with no reference to actual crop experience for the year.

The incentive effects of exclusive presumptions differ substantially from those of the income tax. Exclusive presumptions create no disincentive to earn income. Rather, the incentive effects of the tax will depend on the factors used to determine presumptive income. These incentive effects will be minimal when the factors on which the presumption is based are in inelastic supply, land being the quintessential case. An exclusive presumption is in fact not an income tax at all, but is a tax on whatever is used to determine the presumption. Depending on the factors used, it may be more like a tax on potential income (if based on factors of production) or on consumption (if based on lifestyle).

Exclusive presumptions are administratively simpler than presumptions of the minimum tax type, because minimum tax presumptions require two tax bases to be calculated and compared.

While exclusive presumptions have the advantage of simplicity and minimal disincentive effects, they may suffer from a lack of equity. Taxpayers with substantially differing amounts of actual income must pay the same amount of tax if their presumptive tax base is the same. On the other hand, if the correlation between presumed and actual income is closer than that between actual and reported income, then a presumption may increase equity.

II. Overall Architecture

The appropriate role for presumptive taxation depends on its place in the overall architecture of the tax system. This section considers some relevant aspects of how presumptive taxation can fit in with the rest of the system.

A. Thresholds to Exclude Hard-to-Tax From Tax Net

Instead of applying presumptive methods to all hard-to-tax persons, thresholds can be used to minimize the number of taxpayers that the system has to deal with in the first place. In the case of the income tax, the philosophy of progressive taxation calls for exempting from tax those with low incomes. Establishment of a tax-exempt threshold therefore has the potential to remove from the income tax net a large portion of the hard-to-tax. This has a few implications. First, the tax-exempt threshold should be set as high as possible, consistent with revenue objectives. It does not make much sense to have a relatively low threshold and

low initial rate bracket. Better to set both the threshold and the initial rate bracket higher so as to collect the same amount of revenue, while keeping as many of the hard-to-tax out of the system. Second, a somewhat schedular approach to the individual income tax may be called for. Developing and transition countries often impose final withholding taxes on interest and dividend income. Individuals whose sole income is wages, interest, and dividends therefore do not need to file. A problem can come up if they have both wages and a small amount of business or agricultural income. In principle, they have to file if this total exceeds the threshold. What might be considered is a filing requirement whereby those with a limited amount of part-time income, either farmers earning a limited amount of wages on the side or wage earners with a limited amount of agricultural or business income on the side, would not have to file a return, as long as the total income is below a certain amount. For administrative reasons, keeping these taxpayers out of the system might be desirable, even if there were some violation of the principle of horizontal equity. There is a tradeoff here between concerns about tax fairness, revenue, and tax administration. All I am arguing is that the right answer to this trade-off might not involve complete globalization of income.

Another tax involving a threshold is the VAT. Almost universal advice and practice in developing and transition countries is to set a fairly generous VAT threshold, so as not to overhwhelm administrative resources with small taxpayers. The revenue loss from exempting these taxpayers might not be significant. The revenue loss is limited to the extent that these persons use vatable inputs in their production, since the trader effectively bears the burden of this tax.

The threshold is typically defined in terms of the volume of taxable supplies made over the course of a year. A possible variant would be to define the threshold in terms of the amount of value added (i.e. net rather than gross turnover).[7] The reason for considering this alternative has to do with the above-mentioned point concerning the VAT that a non-registered trader implicitly pays. Under this approach, persons who are not registered traders but who are close to the line of having to register could reduce their taxable turnover for purposes of the registration requirement by obtaining VAT invoices from suppliers. The VAT invoice would have to indicate the trader's name and taxpayer identification number (the general TIN rather than a special VAT number since the person would not be registered for VAT). This approach should allow a substantially higher threshold (in terms of gross turnover) for taxpayers such as retail traders, thereby keeping more hard-to-tax individuals out of the VAT tax net. In principle, very few registered VAT taxpayers should be considered hard to tax. This is because of the extensive recordkeeping and invoicing that these taxpayers by definition have to undertake, under heavy penalties for noncompliance.

B. What Taxes Should Presumptive Taxation Replace?

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[7] *See* Ebrill et al., The Modern VAT 123 (2001).

The question sometimes arises as to what taxes presumptive regimes should replace. The purpose of presumptive regimes is to provide alternative methods of assessing taxpayers who do not keep good books of account. Therefore, the general answer as to what taxes should be replaced is that whatever taxes are based on books of account should be candidates, but no others. For example, a tax that is imposed on ownership of a car does not require any accounting and hence should be collected from small businesses regardless of whether they participate in a presumptive regime. This also makes sense from the point of view of uniform administration of this tax.

C. How to Define Taxpayers Eligible for Presumptive Regimes

Definitions of taxpayers that are eligible for presumptive regimes need to be carefully structured to avoid including taxpayers with higher incomes and those who are or should be capable of keeping accounts properly. There is a political temptation to provide "simplified" (i.e. preferential) regimes for small business and to use presumptive taxation for this purpose. This should be avoided. Instead, the profit or income tax should be kept as simple as possible and simplified accounting rules (e.g., cash method of accounting) should be provided for taxpayers whose turnover is below a specified level. Presumptive taxation should be provided only for those who are not really in a position to keep accounts at all.

Of course, the law cannot use this as a definition. The dividing line that probably makes the most sense is turnover. Conceptually this is relatively simple, but there is a Catch-22 problem. By hypothesis, the kinds of taxpayers we are concerned about are unreliable about keeping track of their turnover. Therefore, in addition to turnover, the law might specify other criteria that exclude taxpayers from eligibility for presumptive regimes. One of these might be the number of employees. Presumptive regimes designed for the very smallest taxpayers (i.e. patents) might exclude altogether taxpayers with any employees. Regimes that are designed for slightly larger taxpayers (tachshiv) might limit the number of employees that a taxpayer can have. In the case of tachshiv, the number of employees can also be a factor in the calculation of presumed income under the tachshiv. Since each tachshiv is tailored to a specific industry, the limits can be different for different industries.

Both patents and tachshivim are industry-specific. If the list of industries is tightly defined and does not include an "other" clause, then the regime is by definition not available to anyone not on the list. Alternatively, if the patent or tachshiv scheme includes a category like "Other services," then it will be appropriate to exclude professional services from this list. This should certainly include services performed in their professional field by anyone with a higher education degree (e.g., doctors, lawyers, accountants, engineers) as well as persons such as stock brokers and real estate agents. If there is a concern that higher-income taxpayers might take advantage of presumptive regimes, the best approach might be to develop a list of categories for the tachshiv and for patents which are carefully defined, so that no one performing an activity that is not on the list will qualify. If worst comes to worst, such persons will be subject to the normal tax regime, and that does not pose a big problem. If there are a lot of such persons, the lists can be adjusted to include additional activities if considered appropriate.

Another possible criterion to exclude taxpayers from presumptive regimes would be total net worth or ownership of high-value assets. For example, in a country where ownership of an automobile is a sign of wealth, individuals who own a car (or whose spouse or dependent owns a car) could be excluded from the presumptive regime. Similarly, an owner of a house could be excluded. In general, one could use criteria similar to those used in taxation on the basis of outward signs of wealth[8] to exclude taxpayers from application of presumptive regimes. A net worth limit can also be set, although it might be difficult to enforce if taxpayers hide their wealth.

Taxpayers can also be excluded from presumptive regimes on the basis of their ability to maintain records. In some countries, all corporations are required by commercial law to keep double entry accounts. In such countries, corporations should presumably be excluded from presumptive regimes. If an entrepreneur is not prepared to keep double entry accounts, the entrepreneur should not incorporate. Another class of taxpayers who should be able to keep proper accounts are those who are registered as VAT taxpayers. For example, a taxpayer whose turnover is low might be voluntarily registered for VAT. Since a VAT taxpayer has an obligation to keep careful records, it can be appropriately excluded from presumptive regimes. Further, even a taxpayer who was previously registered as a VAT taxpayer but subsequently deregistered could be excluded from presumptive regimes on the basis that they should know how to keep records. Whether such exclusion is a good idea may depend on the details of the presumptive scheme in question.

III. Agriculture[9]

In many countries, income from agriculture—particularly in the case of small farmers--is taxed on a presumptive basis if it is taxed at all.[10] The usual approach is to base the tax on the area of land and its quality. An estimate is made of the normal income that can be earned, given the productivity of that type of land, average costs of production, and the price of products. Relief may be provided for when the harvest in an area is bad. Certain activities may be excluded from presumptive taxation, and larger enterprises may be taxed on the basis of actual income.

For example, in France, farmers with a turnover of 500,000 francs or less are eligible for the presumptive basis of taxation.[11] The taxable income from agriculture is determined according to (1) the area of land that is under cultivation or could be placed under cultivation, (2) the type of crop, and (3) the region. For each region, the average profit for each type of

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[8] *See* Thuronyi, *supra* note 1, at 426-29, 430-33.

[9] *See* Ahmad & Stern, *supra* note 3, at 252–59; Richard Bird, Taxing Agricultural Land in Developing Countries 63–66, 147–50 (1974); Lapidoth, *supra* note 4, at 37–40.

[10] *See, e.g.,* EstG § 13a (Germany)(presumptive assessment of certain agricultural enterprises).

[11] This description of the French system is based on Précis de Fiscalité ¶¶ 314 to 342-3 (1994).

crop is determined annually by a committee composed of representatives of the tax administration and farmers. If a natural disaster leads to crop loss in a region, then individual farmers who suffered from the calamity may apply for a reduction in tax on that basis.

Application of such a system requires good information about land quality. While this does not involve such a degree of complexity as determining the fair market value of land, it still presents a substantial challenge. The question is whether a simple system based on categories of land quality is robust enough so as to produce a sufficiently fair result in terms of presumed income. For subsistence farmers, the setting of thresholds may decide the question: if they fall below the threshold for application of the income tax, then it is not necessary to apply a presumptive income tax.

A presumptive system for agriculture also requires attention to specifying the circumstances under which the taxpayer is allowed to apply for relief on the basis that the actual harvest came in below the presumed amount. If the opportunity to make such an argument were open ended, there would be many disputes. Therefore, it probably makes sense to limit this opportunity to cases where there have been harvest failures due to regional disasters or similar reasons.

IV. Contractual Method (Forfait)

The contractual method (*forfait*[12]) used in France is a presumptive method that strives for a fair degree of accuracy. For a time, the *forfait* was widely applicable in France, covering some one million individual business persons as of the 1960s,[13] although its importance has dwindled more recently. Taxpayers are eligible for the system if their annual turnover is below a specified amount. The contractual method differs from other presumptions in that its application is based on advance agreement between the taxpayer and the tax authority to base tax liability on estimated income instead of on actual income.[14]

To apply the *forfait*, the taxpayer must furnish the following information with respect to the preceding year: purchases, sales, value of closing inventory, number of employees, amount of wages paid, and number of cars owned by the taxpayer. The tax administration then calculates the *forfait*, which is supposed to be an estimate of the "income which the

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[12]The term *forfait* is linguistically confusing, because it can refer both to a contract and to a lump-sum payment. According to International Tax Program, Harvard Law School, Taxation in France 345–62 (1966), the term means “contract” in this context. Because *forfait* is also used to refer to other presumptive methods used in France, the term "contractual method" is used here to refer to this particular kind of *forfait*. *See* Précis de fiscalité ¶¶ 1341–62 (1994) for a description of its current operation in France. The discussion above draws from the more detailed discussion in Taxation in France.

[13]*See* Taxation in France, *supra* note 12, at 345.

[14]*See* Lapidoth, *supra* note 4, at 89.

enterprise can normally produce." As can be seen, the information furnished by the taxpayer requires a substantial amount of record keeping and, in fact, constitutes virtually all the information needed to determine taxable income, except for general business expenses. These are furnished by the tax administration, on the basis of industry-specific estimates. Once the administration supplies its estimated income, it is then subject to agreement with the taxpayer. The agreed figure applies for two years, that is, the preceding year and the current year. It may be different for each of these years, and the figure for the second year may be extended for one or several successive one-year periods.

The taxpayer has the option to use regular income accounting instead of the *forfait* method but, if electing the regular method, is bound to use it for three years.

Similar approaches apply in some other countries.[15]

The estimation methods for determining the amount of the *forfait*, which are based on extensive statistical analyses conducted by the tax administration and on a detailed classification of industries, involve a lot of sophisticated work. Moreover, the application of the *forfait* depends on high-quality and honest tax inspectors:

> Since it is the local tax inspector who has authority to reach an agreement with the taxpayer, the caliber of the administration, especially the ability and honesty of the local inspector, is important to the success of the agreed income system.... In sum, the essence of the agreed income system is strong administration at the local level, with supervision at departmental and national levels.[16]

These factors suggest that the *forfait* is likely not appropriate for countries where the tax administration is weak and prone to corruption. These are precisely the countries facing the most serious hard-to-tax problems.

V. Percentage of Gross Receipts

The legislation of some countries[17] provides a minimum-tax type of presumption, whereby the taxable income of a business can be no less than a specified percentage of the gross receipts of the business. For businesses paying tax on this basis, the tax has the same economic effects as a turnover tax, rather than an income tax, although the situation is more

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[15] *See, e.g., Note, The Tachshiv in Other Countries,* 31 Bulletin for International Fiscal Documentation 101 (1977) (describing provisions in the tax laws of several European countries that allow the taxpayer and the tax authorities to agree on a tax assessment); CIR arts. 342 § 1er, 343 § 1er (Belgium).
[16] Taxation in France, *supra* note 12, at 357.
[17] *E.g.,* IT § 23 (Sierra Leone); ET § 180, 188 (Colombia) (repealed as of 1990).

complicated when a company alternates between paying tax on gross receipts and paying tax on income.

It is difficult to see the attractiveness of this type of tax beyond the facts that it is relatively easy to administer and raises revenue. These characteristics are shared by sales taxes. If a sales tax is desired, it should be adopted explicitly, rather than in the guise of a minimum income tax. As a sales tax, the gross receipts tax is defective, because it involves substantial cascading.

The cascading effect of the tax has two dimensions. First, when most firms are taxed on a gross receipts basis, rather than on income, the tax becomes like a sales tax and involves the familiar cascading problem of such a tax. Second, the degree of integration of a firm may determine whether the firm pays tax on a presumptive basis. For example, suppose that the statute provides that minimum taxable income is 5 percent of gross receipts. Firm *X* produces a product at a cost of 96 and sells it to Firm *Y* for 100. In turn, *Y* incurs expenses of 10 and resells the product for 114. In this situation, *X*'s and *Y*'s profit of 4 each would be less than the statutory percentage, and each would instead pay tax on the presumptive basis. However, if the firms merged, producing at a cost of 106 and selling for 114, they would pay tax on the profit of 8, and the presumptive tax would not apply.

A further problem with this type of minimum tax is that there is no close correlation between a particular year's income and turnover.[18] Moreover, net income is likely to represent widely varying percentages of gross receipts depending on the industry concerned, the degree of integration of the particular enterprise, and the type of product or service provided (e.g., a boutique may require a higher profit margin to cover its costs than a high-volume sales operation). Using the same percentage for all companies will therefore be highly inaccurate as a means of approximating net income.

The problem can be addressed, as some countries have done, by classifying taxpayers according to their business and by specifying a profit percentage to be applied to gross receipts, based on industry studies for each type of business to be covered (similar to what is done with the tachshiv). This kind of presumption can be applied as an exclusive way of taxing income, as a minimum tax, or as a *forfait*. This more sophisticated approach reduces the inaccuracy of the presumption, but makes it more complicated to apply, particularly to taxpayers whose operations cross industry lines. Moreover, to be accurate this method requires research into actual profit margins, an effort that involves significant resources and may be difficult to accomplish in conditions of general economic instability. Therefore, it would be more suitable for some countries than for others.

The receipts-based presumptive tax can also encounter enforcement problems and result in unevenness of application. If taxpayers fail to declare their gross receipts, they can

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[18] *See* McLure et al.,The Taxation of Income from Business and Capital in Colombia 144 (1990).

avoid the presumption. So the basic audit problem of determining gross receipts is not addressed by this type of tax. Accordingly, it is not likely to be effective in raising revenue from the types of taxpayers whose gross receipts are difficult to ascertain, such as independent professionals, and is more likely to impinge on those taxpayers who cannot hide their gross receipts.

As with other minimum taxes, the apparent simplicity of the receipts-based minimum tax is undermined by the need to make complicated adjustments for taxpayers who alternate between paying tax on a presumptive basis and paying the regular income tax.[19] If such adjustments are not made, then the presumptive regime can involve a disproportionally high tax liability for taxpayers whose income tends to fluctuate substantially from year to year.

In drafting rules for such a minimum tax, it is necessary to specify which taxpayers are subject to the tax and what items are included in gross receipts. For example, one could specify that gross receipts include all receipts of a business and that both individuals and corporations are subject to the tax. This requires determining what receipts are business receipts. Should items such as interest, dividends, and rents be treated as business receipts and, if so, under what circumstances? It may make sense to exclude such items from business receipts for purposes of the minimum tax, in part because the profit margin is likely to be higher than for other business receipts. It would be most accurate to compare the specified percentage of business receipts against taxable business income, and then to tax investment income separately. Under such an approach, expenses must be allocated among business and investment income, not always an easy exercise. On the other hand, if all receipts are lumped together, then it is easier to engage in tax planning to avoid the tax. For a taxpayer whose profit margin is low, so that it has to pay the gross receipts tax, the game would be to earn enough financial income (where the profit margin is higher), so as to bring the average profit margin up to the level specified by the gross receipts tax.

An alternative that some countries have adopted[20] is to make the gross receipts presumption rebuttable. Although this alternative takes care of many of the problems of the gross receipts tax, it also takes most of the teeth out of this type of minimum tax.

Where applied as an exclusive presumption to tax very small businesses, the gross receipts method avoids some of the problems described above. Cascading will not be a problem if the only taxpayers subject to the regime are small businesses, since vertical integration is of limited relevance. Moreover, the exclusive nature of the presumption means that rules to coordinate the receipts-based method with the regular income tax are not needed, since the regular tax simply will not apply to these taxpayers. The lack of close correlation between gross receipts and taxable income in a particular year is not a concern, as long as over the medium term the gross receipts method yields a reasonable result. The main difficulty lies in determining an appropriate percentage to apply to gross receipts.

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[19] *See* McLure et al., *supra* note 18, at 142–43.
[20] *E.g.,* IT § 23(3) (Sierra Leone).

VI. Fixed Amount Based on Profession or Trade (Patent)

Some countries apply a minimum tax based on an individual's profession or trade.[21] To avoid serious inequity, the presumptive amounts must be set at rather low levels. They are thus ineffective in taxing higher-income professionals. Indeed, if the presumptive tax raises substantial revenue, this is a sign that there is something seriously wrong with the regular tax. Perhaps these presumptive amounts are better than nothing, however. A slightly more refined alternative is to divide taxpayers within a given industry into two or three classes based on turnover, with a fixed tax for turnover within each band.[22] Taxpayers may also be divided into categories based on the type and amount of capital equipment used in the business; for example, owners of slot machines could be taxed on a fixed amount for each machine owned.[23] A distinction is also sometimes drawn based on the number of years a person has been out of school. If the presumption is applied as an exclusive presumption rather than as a minimum tax, it is important to specify a turnover ceiling above which it no longer applies, or otherwise to define which taxpayers are excluded from this system (see II C above).

The basic problem with the patent approach is that it treats equally all taxpayers within a given class, regardless of their actual income. This can be remedied only by using a more complex approach which is based on a number of factors (see discussion of tachshiv below). While the patent can be used to tax low-income entrepreneurs, the question arises why they need to be paying tax at all. If their incomes fall below the thresholds for taxation specified for the income tax or the VAT, then perhaps the tax system should not be dealing with them at all, and they should satisfy their obligation to contribute to public expenditures through the VAT that they pay when they make purchases either for consumption or business use. A possible reason for using the patent approach for these cases is as a substitute for social contributions, whch might be payable even if the taxpayer does not have to file an income tax return.

The distinction between the patent and the tachshiv does not seem too clear. The patent seems to be applicable mostly to individuals working alone without employees. The amount of tax is based on the type of activity, and perhaps on location (rural or urban, or possibly with different rates in different localities, especially in cases where the patent is a local tax). On the other hand, the tachshiv attempts to apply a more complex multi-factor approach to estimating income.

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[21] *See, e.g.,* SBT art. 3 (Albania); TC art. 138(1) (Kazakhstan). *See* Lapidoth, *supra* note 4, at 33-35 for discussion of standard assessments in Ghana, which were fixed amounts for specific trades.

[22] *See* Richard A. Musgrave, *Income Taxation of Hard-to-Tax Groups in* Taxation in Developing Countries (Richard M. Bird & Oliver Oldman eds., 4th ed. 1990).

[23] *See* Lapidoth, *supra* note 4, at 34.

VII. Standard Assessment Guide (Tachshiv)

Standard assessment guides (*tachshivim* as used in Israel,[24] subsequently replaced by *tadrihim*) and similar methods are used in several other countries.[25] I will call them all tachshiv for convenience. The *tachshiv* is based on various ascertainable factors, which are developed for particular industries. For example, a restaurant may be taxed on the basis of location, number of seats, and average price of items on the menu. The objective is to determine net profit. The *tachshiv* does involve an element of agreement between taxpayers and the tax authorities, but the agreement is on the *tachshiv* in general (being negotiated with industry representatives), not on its application to particular taxpayers.

Although the general approach of the *tachshiv* is similar to that of the *forfait*, its legal status in Israel is different. It was not specifically authorized by the statute, other than being covered by the general authority to make best judgment assessments. Since the *tachshivim* were published, taxpayers in practice have relied on them, failing to keep or disclose adequate records in situations covered by a *tachshiv*, particularly when the results were advantageous to the taxpayer. One implication is that the *tachshiv* system resulted in understatement of tax, since it was a one-way street: taxpayers would rely on the *tachshiv* where favorable but keep records where that would be more favorable. While the existence of the *tachshiv* system did not relieve taxpayers of their obligation to keep adequate records, in practice taxpayers were not penalized for such failure. In reviewing cases involving assessment based on a *tachshiv*, courts held that the assessment could be altered by the court if the taxpayer could show that it was arbitrary in the particular case.

Another important difference between the *tachshiv* as applied in Israel and the *forfait* is that the latter is available only to taxpayers with a turnover below a specified amount, whereas the *tachshiv* is not so restricted.

Use of a method such as the *tachshiv* may be effective in extracting tax from small taxpayers in certain industries, but it is not easy to apply. Considerable background work is required by the tax authorities in specifying the factors to be used for particular industries and the relevant multipliers for each factor. Application of this method thus requires an investment in administrative infrastructure and adequate preparatory time. The method will be more suitable for some industries than for others. The key is whether the business is such that turnover can be ascertained from external evidence. Where it can, a *tachshiv*-type approach may be appropriate, provided that adequate administrative preparation is made.

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[24]The discussion here is based on Arye Lapidoth, *The Israeli Experience of Using the Tachshiv for Estimating the Taxable Income*, 31 Bulletin for International Fiscal Documentation 99 (1977). Other countries using similar methods include Spain and Turkey. The Musgrave proposal is also similar. *See* Musgrave, *supra* note 22.

[25]*See, e.g.,* IRPF art. 69 (Spain) (determination of income of small and medium enterprises on the basis of objective factors).

In drafting provisions for standard assessments, it would be better to avoid the uncertain legal situation experienced by Israel and instead to provide statutory authority for their use. Because the determination of standard assessments involves considerable detail and empirical research, the details for their application cannot be contained in the statute. The statute might usefully specify criteria for excluding taxpayers from the presumptive system (section II C above). An important issue is whether for eligible taxpayers the standard assessment should be elective or mandatory. The preferable solution is to provide for mandatory use of the standard assessment for eligible taxpayers, but to allow the taxpayer to make an irrevocable election to use the normal accounting rules instead. This approach prevents the taxpayer from taking advantage of the system by moving in and out of using the presumptive system, or waiting to see which of the alternatives is more desirable in a particular year.

For countries with weak tax administrations, the prospect of using a tachshiv-type system presents a dilemma, because it requires sophisticated and extensive work to set up. A country with scarce human capital in its tax administration would likely not be willing to devote the resources to developing a top-notch tashchiv system, if other tax administration priorities are much more pressing and if the amount of revenue to be derived from this taxpayer group is relatively small. A possible approach would be for a consortium of countries to get together with international donors to work out a set of tachshivim in a representative country (or countries, with different countries taking on different sectors). The overall methodology should be the same for countries in the same region, and it should be relatively simple to make the necessary adjustments for use in a particular country once a full set was developed. The team should include economists, lawyers, tax administrators, and statisticians. Presumably a year or two of intensive effort could produce the set of manuals, which could then be tested and adapted for use in other countries.