



Russian-European Centre for Economic Policy (RECEP)

Российско-Европейский Центр Экономической Политики (РЕЦЭП)

**Taxation mechanisms based
on simplified and indirect evaluation
of tax liabilities**

S.N. Makedonskiy

2005 Moscow | Москва 2005



This project
is funded by the EU

Этот проект
финансируется ЕС



Tel (7-095) 926-0411
Fax (7-095) 926-0299
E-mail info@recep.ru
Web www.recep.ru
Russia 107996 Moscow, K-31, GSP-6
Kuznetsky most str., 21/5, entr.1



This project is implemented by the
Bureau of economic management
and legal studies
Этот проект реализует Бюро
экономического менеджмента и
правовых исследований

S.N. Makedonskiy

**TAXATION MECHANISMS
BASED ON SIMPLIFIED
AND INDIRECT EVALUATION
OF TAX LIABILITIES**

Moscow, 2005

Contents

INTRODUCTION.....	3
Basic terms and definitions	3
Purpose and scope of presumptive taxation	3
Contents and structure of the paper	5
1. TYPES AND BASIC METHODS OF PRESUMPTIVE TAXATION	7
1.1. Rebuttable vs. irrebuttable taxation.....	7
1.2. Minimum vs. exclusive presumptive taxation	8
1.3. Mechanical vs. discretionary method of presumptive taxation	9
2. MAJOR KINDS OF PRESUMPTIVE TAXES.....	9
2.1. Simplified taxes	9
2.2. The forfait system.....	15
2.3. Imputed taxes	16
2.4. Patent form of taxation	20
Ukraine. Trade patent	22
2.5. Minimum taxes	22
2.6. Presumptive withholding taxes	25
2.7. Presumptive taxes on imports.....	25
3. INDIRECT TAX LIABILITY ASSESSMENT METHODS.....	27
3.1. Conditions for indirect assessment of income.....	27
3.2. Method of economic analysis.....	28
3.3. Cash proceeds method.....	29
3.4. Method of analysing information about taxpayer's income and expenditure	29
3.5. Statistical methods.....	30
3.6. Method of special estimated indicators	31
3.7. Method of stereotypes.....	31
3.8. Net property value assessment method.....	32
3.9. Cash deficit calculation method.....	32
3.10. Cash flow calculation method	33
3.11. Method of reimbursement of costs.....	33
3.12. Method of correcting indicators	33
CONCLUSIONS.....	35
BIBLIOGRAPHY.....	41

INTRODUCTION

Basic terms and definitions

Tax systems of different countries include taxes accrued on the basis of simplified accounting, or using indirect methods of tax liability assessment. In the English-speaking countries the tax payments of such kind are called **presumptive taxes**. The totality of the said taxes, ways and methods for their accrual comprises the special tax treatment within the national taxation system labelled with the term **presumptive taxation**. This notion incorporates also methods of monitoring or adjustment of liabilities related to the payment of regular taxes (i.e. belonging to the general taxation treatment) alternative to the accrual on the basis of the taxpayer's financial statements.

Meanwhile, respective notions and terms are missing from the Russian tax law¹. The word “*presumptive*” in English points at the legal origin of the term and means that there are reasonable presumptions about the taxable income of the taxpayer. However, the literal translation of the term into Russian is not exactly suitable for operating it as a taxation term*.

Purpose and scope of presumptive taxation

The ability of the tax system to adequately perform its functions is to a large extent determined by its correspondence to the economic environment along with certain principles and requirements. Specifically, tax burden should be fairly distributed among all the economic entities depending on their taxable capacity. The implementation of this principle is, however, hampered by the informal (unregistered) economic activity and active tax evasion by a significant part of the taxpayers.

Another problem and, simultaneously, an important task of the state is the establishment of the economic environment favouring all kinds of socially useful

¹ In Russia, the following taxes attributable to presumptive taxes and designated as a special tax treatment scheme are applied: simplified taxation system (single tax collected in connection with the application of the simplified taxation, accounting and reporting system); taxation in the form of single tax on imputed income for some activities; single agricultural tax. It should be noted that some tax payments that in terms of the method of assessment and functional purpose correspond to presumptive taxes, are traditionally considered a part of the general system of taxation and usually not viewed in the context of special treatment. In a more general sense, the taxes on gambling business, transport tax, natural persons' property tax, a number of fees for using natural resources as well as specific and combined customs duties can be considered as belonging to presumptive taxes.

entrepreneurship. Special support should be received by small enterprise and self-employed single entrepreneurs.

Meanwhile, tax systems of the majority of countries were meant from the beginning for targeting large and medium-size companies with the highest level of “budget efficiency” from the point of view of tax administration. As a results, small business as a rule finds unacceptable the costs and difficulties associated with the accountancy and submission of statements in accordance with the general tax treatment.

The above issues constitute the major reasons for the application of *presumptive taxation*. Special treatment schemes and methods for the assessment of tax liabilities are to a larger extent taking into account the particular features of specific groups of economic entities compared to the general tax treatment. Presumptive taxation employs relatively simple rules for the accrual and payment of taxes for those economic operators, which often avoid regular taxation.

Substantial for the configuration and functioning of the tax system are the factors reflected in such indicators as relative size of shadow economy, corruption level (also within tax authorities)² and consent of the taxpayers to observe the tax law. Comparative analysis by macro-regions shows also that the results of the application of similar schemes of presumptive taxation depend to a large extent on the socio-cultural and general economic environment.

The largest scale of informal economic activity and tax evasion is found in the developing countries of Africa and Latin America and for the majority of countries with economy in transition. Respectively, presumptive taxes became most wide-spread in the developing African and Latin American countries. Over the last decade they have also been applied in the countries with economy in transition.

Developed countries, in the framework of the long-term strategy aimed at the promotion of taxation on the basis of financial accounting are gradually restricting the application of special tax treatment. At the same time, the methods of indirect assessment of tax liabilities are increasingly applied in the developed world.

For the purposes of advancing the Russian tax system, the experience of presumptive taxation in the developing and transition economy countries is of no smaller value than the

² Relative size of the “shadow economy” is directly linked to the level of corruption. Firstly, the corruption sector as such is a part of the illegal component of the “shadow economy”. Besides, the bribing of officials usually takes place at the expense of the funds “spared” on taxes.

one of the countries with developed free-market economy³. It is also necessary to take account of the effective tax treatment (both general and special one) in Russia's neighbour countries for the purposes of establishing the common economic space of the CIS.

Contents and structure of the paper

The first section describes the *types and methods of presumptive taxation* described for the most part from the point of view of their legal aspects. The type and methods of taxation are divided with regard to: endowment or non-endowment of the taxpayer with the right to contest tax assessment; the degree of the freedom of tax authorities to act at their discretion while assessing the tax liabilities.

The second section describes *major kinds of presumptive taxes*.

The classification chosen to characterise the presumptive taxes reflects the assessment method, basic functional purpose and scope of application of those taxes. The classification approach chosen in this paper requires some explanations.

Simplified taxes are the taxes where simplified accounting and reporting forms are used for computation of the taxable base and collection of the tax. The taxable base for the simplified taxes is usually represented by the indicators of turnover, value of assets and results of the economic activity.

Imputed taxes are in their majority the taxes on imputed income. As a rule, they are based on the assessment of the return of the production factors. In the most simple version (for example, in the event of patent tax) this can be an average assessment of profitability for a certain type of entrepreneurship not associated directly with accrual procedures for specific economic entities.

It might be hard, however, to identify in the tax practices of different countries the simplified and imputed taxes in the pure form. In many cases, special treatment consist of a combination of various types of presumptive taxes⁴. Therefore, the classification of taxes presented in this paper is somewhat relative.

³ One can refer here to the fact that the reform of the tax systems in the developing countries (that took place mostly in the '80s and '90s) and countries with economy in transition was performed with involvement and following the recommendations of the experts from the developed countries and international organisations (in particular, IMF and World Bank).

⁴ For example, under the Russian simplified system the taxpayer who uses the income reduced by the amount of expenditures as the taxation basis, is obliged to pay minimum tax in the event the amount of tax accrued under the general procedure is smaller than the accrued amount of minimum tax. The amount of minimum tax is determined as 1% of the taxable base, i.e. income.

Thus, the first group includes taxes, which are mostly attributed to the category of *simplified taxes*. The second group includes the French *forfeit* system. The third group includes presumptive taxes, of which the majority are *imputed taxes*. The fourth group is meant to single out *patent taxation*.

The four latter groups of the tax payments are applied for the most part to small business entities. The major purpose of their application consists in making easier the market entry conditions and inclusion in the legal economic activity of as many small business operators as possible.

The fifth group is composed of the presumptive *minimum taxes*, applied to different size economic operators.

The sixth group includes presumptive taxes withheld at source (*withholding taxes*), comprising a kind of minimum taxes, but having their own functional destination and scope.

The seventh group views the presumptive *taxes on imports*, which differ due to their scope of application. The destination of the latter two kinds of presumptive taxes with regard to small business is same as with the taxes of the first four groups. On the contrary, the application of *minimum taxes* to medium and large businesses is aimed at preventing the understatement of tax liabilities on “regular” taxes.

The presumptive taxes effective in different countries are covered only briefly in this paper. However, some taxes are examined fairly thoroughly as a case study. One should remember that national tax systems are regularly changing and therefore some data from the sources quoted could have become outdated by now.

The third section features the description of presumptive taxation methods based on the *indirect assessment of the taxable base* of economic operators, which are in effect within the general tax treatment framework. Those methods are directed for the most part at fighting the tax evasion in the form of understatement of tax liabilities on the part of large and medium enterprises.

The Conclusions contain findings and reflections about the relevance and prospects for Russia of applying certain kinds and methods of presumptive taxation.

1. Types and basic methods of presumptive taxation

1.1. Rebuttable vs. irrebuttable taxation

The *rebuttability* as regards presumptive taxation involves for the taxpayer the opportunity to justify that his tax liability accrued on the basis of general taxation rules is smaller than the one calculated under the conditions of special treatment. In other words, the taxpayer can arrange the reduction of his tax liabilities with the tax authorities in the framework of an *administrative procedure*.

The *irrebuttability* means that that taxpayer cannot contest his liability on the basis of proving his actual income. Thus, irrebuttable taxation imposes restrictions on the rights of the taxpayer under special treatment. Therefore, the application of irrebuttable taxation requires a greater precision in terms of legislative determination of the procedure for application and accrual of the tax.

Depending on the degree of rebuttability, mixed types of taxation can also be introduced. For example, the Russian system of simplified taxation and the French *forfait* system are rebuttable in the sense that the taxpayer has a right to choose between special treatment and general taxation procedure. However, if the Russian or French taxpayer (as a result of negotiations with the tax inspector) chose special treatment, the tax becomes irrebuttable.

The need for rebuttability of taxation can also arise in the event of general tax treatment, when the taxpayer is not submitting a declaration or there exist reasons to assume that the data he submitted is not adequate. In such cases the law usually allows the tax authorities to apply indirect methods for assessing the taxpayer's income. Because the application of indirect methods is meant for determining the actual income, the taxpayer is endowed with the right to submit the data contesting the assessment made by the tax authorities. The resolution of dispute between the taxpayer and tax authorities applying indirect methods of determining the tax liabilities on regular taxes is made in court rather than by an administrative procedure.

The countries where irrebuttable presumptive taxes have been introduced witnessed a large number of lawsuits. Therefore, the establishment of the rebuttable type of presumptive taxation increases the degree of its acceptance by taxpayers and reduces the respective legal and court costs [14]. Rebuttable taxation encourages small enterprises to conduct

accounting. In this context, the presumptive tax rates can be set at relatively higher level, since the tax liabilities of some taxpayers which were found excessive can be adjusted.

At the same time, the experience of African countries shows that rebuttable taxation can facilitate the spread of corruption in tax and court authorities.

1.2. Minimum vs. exclusive presumptive taxation

Irrebuttable presumptive taxes can be, in turn, divided into two subcategories: presumptive *minimum taxes*⁵ and *exclusive taxes*.

Presumptive minimum tax establishes a tax liability that cannot be smaller than the liability established according to the rules of presumptive taxation.

Presumptive exclusive tax establishes a tax liability exclusively on the basis of the rules of presumptive taxation, even if application of the general taxation rules may lead to higher tax liabilities.

As an example of the presumptive exclusive tax can serve agricultural tax, the basis of which is determined only by the value of the land, regardless of the actual crop yields.

Because tax liabilities do not depend on the actual income, an exclusive tax encourages the efforts of the taxpayer to earn extra income. In other words, such tax does not affect the taxpayers' marginal yield. Exclusive taxes are very similar to non-distorting lump-sum taxation. Stimulating effect of the tax depends on the factors used for the assessment of marginal yield. Such effect will be smallest if the supply of factors is not elastic (e.g., land is namely such a factor).

In fact, presumptive exclusive tax is the tax on the accountable factors, rather than a tax on the income. However, it can be compared to the tax on potential income, if production factors are taken into account, or profit tax, if it is assessed on the basis of the lifestyle.

The exclusive presumptive taxes are relatively simple in comparison with minimum presumptive taxes because the latter require assessment and comparison of the two taxable bases. At the same time, the drawback of the presumptive taxation is the frequent violation of the principle of fair taxation. Thus, the taxpayers who differ significantly in terms of the actual income, are charged identical amounts, if they have an identical taxable base.

⁵ Presumptive minimum taxes on the basis of different criteria (see Introduction) are discussed in Section 2 of the paper. The "legal" subcategory of minimum taxes described here corresponds to the "functional" "subcategory" described in Section 2, i.e. *alternative minimum taxes*.

1.3. Mechanical vs. discretionary method of presumptive taxation

One can also identify two methods of presumptive taxation on the basis of the degree of freedom (discretion) provided to the tax authorities for the definition of tax liabilities: *formal (or mechanical) methods* and *discretionary methods*.

In case of the *mechanical methods of presumptive taxation* tax liabilities are determined in accordance with the preliminarily set rules.

Discretionary methods of presumptive taxation imply high degree of freedom of the tax authorities when determining tax liabilities.

Discretionary methods are, as a rule, rebuttable, since otherwise the tax authorities would get too broad opportunities for arbitrary actions.

Mechanical methods can be both rebuttable or irrebuttable. In some cases the method can be mechanical and irrebuttable, however, the tax authorities can be free to apply or not apply it upon their discretion.

There are shortcomings to both mechanical and discretionary presumptive taxation methods. The application of discretionary methods creates pre-conditions for corruption. Mechanical methods can lead to excessive taxation, since they do not take into account the specific circumstances of individual taxpayers. Generally speaking, in the case of limited administrative resources is appropriate to use formal methods of presumptive taxation.

2. MAJOR KINDS OF PRESUMPTIVE TAXES

2.1. Simplified taxes

The simplified presumptive taxes do not require complex financial accounting and are simple enough for the taxpayers and tax administration. These taxes replace completely or partially all the taxes paid under the general tax treatment. Simplified taxes are most widely spread in the African countries. In the recent years they have also been introduced in the countries with economy in transition.

The taxable base for simplified taxes is composed of the approximate estimates of various indicators of income or results of the economic activities calculated on the basis of simplified schemes. The criteria that should be met to be able apply the simplified taxation, as a rule, include the upper limits (thresholds) with respect to the taxable indicators and number of employees. The lower limits can also be set, in the framework of which the

favourable or zero rate of simplified tax (exemption limit) can be applied. The scale of tax rates can be graded depending on the value of the applied indicators.

For example, in **Lithuania** the simplified taxation can be upon their option chosen by small enterprises with gross income of not more than 100 thousand lits (US\$ 26 thousand) per year.

In **Romania** micro-enterprises with the number of workforce up to 10 persons and gross annual income up to 100 thousand Euros pay tax collected from the gross income at the rate of 1,5%.

In **Albania** for micro-enterprises with the annual turnover of up to 2 million leks (US\$14,000) a fixed rate is applied. Small enterprises with the annual turnover of 2-8 million leks pay the single tax at the rate of 4% of the turnover [5].

The majority of countries with simplified tax treatment are like Russia using the tax rates which are common for all kinds of the entrepreneurship. Such approach does not take into account the fact that profit margins may differ significantly by sector. Therefore, in some countries the established rates are differentiated by the kind, scale and sector of entrepreneurship.

In **Kyrgyzstan**, in 2002 the simplified taxation system set the rates of 5% and 10% depending on the annual receipts and type of business. The draft of the new Kyrgyz Tax Code provides for differentiated rates from 3% to 10% depending on the kind of activity and limitation on gross receipts up to the amount of 5 million soms per year. Simplified tax, in particular, replaces the payment by entities of the profit tax and motorway usage tax, while for the individuals it replaces income tax (with the exception of the income tax withheld from hired wage earners).

In **Uzbekistan** the single tax on gross income has been introduced since 1998 with respect to the gross income of wholesale trading companies at the rate of 3-5%, and for catering businesses at the rate of 7%-10 %. The rates depend on the location of the company. The single tax replaces the profit tax, VAT, real estate tax, land tax and some other taxes.

In some countries a relatively high degree of differentiation of the taxpayers in the framework of simplified taxation is envisaged.

In **Brazil**, for instance, the simplified taxation at the rates of 3% to 7% is applied depending on the annual gross revenue. The criteria to recognise the taxpayer as a micro-

enterprise is also its gross revenue. The annual income of a micro-enterprise should not exceed 120 thousand reals, while of a small enterprise - 720 thousand reals. Still other criteria and restrictions may feature the following indicators:

- form of ownership;
- the kind of activity and provided services⁶;
- participation in the authorised capital of the company of certain persons (foreign citizens and legal entities; companies co-owned by a public institution) and participation of the company in the authorised capital of other legal entities;
- effecting of export and import transactions;
- presence of accounts receivable with respect to obligatory payments including social insurance;
- exceeding by the owner of the threshold value of the total revenue for the company and participation in other companies.

In **Mexico**, simplified tax treatment based on cash flow has been introduced in 1991 for a number of sectors (agriculture and forestry, fisheries, transport) and small entrepreneurship. Automatic (without need for justification) deductions reduced the taxable base by 15% for freight transport, by 10% for tourism transport and by 60% for the urban public transportation. Besides, the simplified tax treatment sets zero tax rate for numerous small-size taxpayers. The share of sectors that used simplified treatment made 16,3 % of the GDP, however, in terms of the tax proceeds going to the public budget their share made only 0,022 % of the GDP.

The main purpose of the simplified treatment was easier tax administration, while the analysis of the possible consequences did not take place. In Mexico it is considered that the introduction of the simplified treatment provided a sufficient support to the respective sectors. Nevertheless, it was hard to cancel the practice of “free distribution of preferences”. The main benefits were obtained by the transport companies, which defended persistently their preferences and in response to their lifting could have suspended the entire transport communication in the country ([2], p.44-45).

In **Armenia** the tax on small enterprises covers three types of businesses: tradesmen pay 4% of the revenues; food suppliers pay 7%; for other types of commercial undertakings the rate is 7% if the revenues are up to 30 million drams and 12% if that threshold is exceeded [5].

⁶ Special treatment does not cover credit and financial, insurance, leasing, investment and security companies; the companies involved in transactions with securities, currency, real estate, providing the services of a stock-broker, trade representative, medical doctor, dentist, etc.

In **Kazakhstan** the simplified tax on gross revenues is established for natural persons at the rate from 4% to 11% and from 5% to 13% for legal entities. As a rule, the simplified taxation systems do not make distinction between natural and legal entities. Therefore, Special tax Treatment Based on Simplified Accounting that introduced in Kazakhstan the tax rates that are not only progressive, but also different for natural and legal persons, is rather unique [5].

It might be useful to look more thoroughly into the application of simplified tax treatment in France and Ukraine. In France, special tax treatment schemes have been applied for many decades and became a base model for many countries. Ukraine, in turn, like many other countries with economies in transition, is in the process of the establishment of national tax system and initial shaping of special tax treatment schemes. At the same time, Ukraine is different from other Eastern European countries in the sense of greater variety of presumptive taxes.

In **France** at the moment the system is effective whereby several options for simplified taxation are offered. The eligibility for the specific version depends on the taxpayer's turnover.

The taxpayers, who enjoy the right for special treatment as *micro-businesses* should meet the following requirements:

Annual turnover (excluding VAT) does not exceed:

- 500 thousand FF for commerce;
- 175 thousand FF for the service sector and non-profit activities

Special tax treatment for micro-enterprises does not apply to partnerships. With respect to commercial and professional activities it only applies to self-employed single entrepreneurs.

Taxpayers, whose turnover is less than the indicated amounts do not have to go through VAT registration or maintain VAT accounting.

The taxpayer submits information about the size of the turnover in the declaration turned in to the tax authorities, who determine the amount of payment.

The taxable base is determined as the turnover after deduction of the following amounts:

- commerce: the turnover reduced by 70%;
- service provision: by 50%;
- other economic activities: by 35%.

To amounts obtained as a result of the reduction regular income tax rates are applied. The losses do not lead to the reduction of the tax base and are not transferred to the future periods.

Micro-enterprises are relieved from VAT (if the taxpayer does not choose the common tax treatment), which means the absence of:

- obligation to keep VAT records;
- VAT payments;
- “entry” VAT;
- the possibility to apply the VAT refund

The taxpayer conducts simplified income and expenditure accounting, while on the copies of the invoices a note is made about the relief from VAT.

Small and medium enterprises can use another simplified tax treatment pattern, which requires registration as a VAT taxpayer. The requirements to accounting and reporting with regard to income and expenditure are somewhat lower compared to large enterprises.

The range of threshold limitations on the size of annual turnover (without VAT) is:

- from 500 thousand FF to 5 million FF for commerce;
- from 175 thousand FF to 1,5 million FF for service provision or commercial activities if the taxpayer is subject to BIC treatment (for industry and commerce);
- above 175 thousand FF, if the taxpayer is a natural person and the turnover is sourced from services or non-profit activities (i.e. the taxpayer is subject to BNC tax treatment).

The taxable income is determined on the basis of actual income and expenditure and the net losses can be transferred to the future periods.

The taxpayer involved with the service sector can enter the declaration for the consideration of the official auditor, who can allow further reduction of the taxable income (declaration controlee).

Under such treatment pattern the small and medium enterprises enjoy reduced corporate income tax rate for the part of the taxable result (including capital growth), if the following basic requirements are met:

- they are subject to corporate income tax;
- annual turnover does not exceed FF 5 million (without VAT);
- at least 75% of the capital is directly or indirectly owned by natural persons;
- the part of the income taxed according to preferential rate should be used to for increasing the enterprise’s capital

The preferential rate in 2004 made 15,45%, the general rate of corporate income tax being 35,43% (of which 33,33% was the standard rate, 1% - additional taxation, 1,1% - additional social tax).

The simplified treatment establishes quarterly advance payments, the final settlement is made upon presentation of the tax declaration. The data on VAT is also supplied by the taxpayers on the quarterly basis and not monthly as it is envisaged by the general tax treatment.

In Ukraine the special tax treatment includes, in particular: *single tax on natural persons; single tax on legal entities; special trade patent; fixed tax; trade patent.*

The three latter taxes belong to the patent form of taxation. The single tax on natural persons is, in essence, an imputed tax. In the context of the proposed classification these types of presumptive taxes (with the exception of the trade patent⁷) are discussed below.

The single tax for legal entities relieves the business entities from the corporate profit tax, land and some other fees⁸.

Single tax may not cover:

- business entities that purchase a special trade patent;
- trust companies, insurance companies, banks and other credit institutions and non-banking financial institutions;
- business entities in whose authorised stock the shares belonging to legal entities that are not small enterprises exceed 25%;
- business entities involved in joint activities;
- business entity whose founder or one of the founders is a non-resident (business or legal entity) regardless of the size of the capital belonging to the non-resident in the authorised stock of the enterprise.

Also, the following requirements should be met:

- the number of hired wage earners over the calendar year should not exceed 50 persons;
- annual receipts should not exceed 1 million grivnyas;
- the barter transactions are prohibited.

One can choose to pay one of the 2 kinds of the single tax:

- 6% of receipts (without excise charges) upon the payment of VAT;
- 10% of the total receipts (without excise charges) with a relief from VAT⁹.

⁷ Special trade patents have been cancelled as of October 1, 2003. However, the Association of Ukrainian Cities has applied to the Supreme Rada with a request to resume their issue. (<http://news.finance.ua/ru/~1/0/ua/2003/07/09/35860>).

⁸ Relief from mandatory social insurance charge is also envisaged. However, the respective provisions have not yet been enacted into law.

The payers of single tax are not relieved from the income and expenditure accounting and submission of reports. The accounting and reporting in this case is made as simple as possible. Reports are submitted once per quarter.

Examples of abandoning the special tax treatment approach are found in the recent years in the countries with economy in transition.

For example, in **Slovakia** in 2001-2003 a simplified tax at the rate of 2% to 2,75% of gross income and special tax discounts was introduced for small businesses. The entrepreneurs could also choose to be charged a simplified tax if their total revenue during the previous year did not exceed 2 million Slovakian crowns.

However, in 2004, in order to achieve higher degree of tax transparency and minimise deviations in the economic development, all exceptions and special tax treatments have been withdrawn. Simultaneously, through a radical tax reform, the corporate income tax rate was reduced from 25% to 19% and the same rate was established for the incomes of natural persons ([10], p.211-212).

The main advantages of simplified taxes consist in their relative simplicity both for the taxpayers and for tax administration. Their major shortcomings include inconsistency between the assessment of income on the basis of the utilised indicators and actual income of the taxpayer. In the case of simplified taxation the differentiation of taxpayers in terms of profitability of their business depending on the kind and sector of their activity and regional specifics is virtually not considered.

The problem of “thresholds” which is important for all presumptive taxes becomes most aggravated under the simplified taxation schemes. This problem is, among others, manifested in the artificial fragmentation of companies for the purpose of qualifying for preferential tax treatment.

2.2. The forfait system

The *forfait* (contractual system) in France comprises small businesses including farmers, whose income is below the established level. The imputed income of the farmers is determined in the form of “collective assessments” that are calculated for the groups of farmers with regard to the type, location and size of the business. The evaluation of income,

⁹ In 2004, a draft law was submitted to the Ukrainian Cabinet where, in particular, it was proposed to reduce the rate by two times, up to 3% - 5% (<http://bgs.com.ua/news/archive>).

and, respectively, tax liabilities of self-employed individuals (professionals) is based on the concept of “normal income”, i.e. regardless of contingent losses or exceptional profits.

To other small entrepreneurs apply “individually defined assessments” Those assessments are made in the following way:

- the taxpayer provides the data about annual sales volume, procurement volume, value of purveyance (at the end of the year), number of the employed people, salaries paid out, motor vehicles owned;
- the tax authorities accept or request to correct the declaration of the taxpayer;
- the final assessment of the income is made by the tax authorities according to a carefully outlined procedure and methodology using additional information (regional directories on the profitability of various activities, location, etc.).

The taxpayer may contest the assessment by tax authorities, however, if it is confirmed, the tax liabilities are established for the period of two years.

The *forfait* system does not relieve the taxpayer from all the accounting responsibilities. However, the taxpayer can choose between the simplified accounting and general taxation treatment with the respective type of accounting, while still remaining in the framework of the *forfait* system.

The systems of simplified taxation similar to *forfait* used to be common for the French-speaking African countries. The taxes were established in relation to the estimated turnover. However, the small business entities as a rule did not maintain any accounting and the *forfait* mechanism practically did not work. Moreover, in those countries, where the corruption inside tax authorities poses a serious problem, the contractual approach according to the *forfait* method became a “disaster recipe” [12]. As a result the African countries have switched from the simplified taxation system on the basis of *forfait* to the taxation of imputed income ([3], p.15-16).

Currently, the *forfait* type tax systems are used in Spain and Belgium.

2.3. Imputed taxes

Most of the *imputed taxes* are assessed on the basis of the estimated average factor return (for factors with average replacement elasticity) or estimated return from a certain kind of the economic activity.

Theoretically, the resource taxes are not the best suited ones for a competitive economy¹⁰. However, they are more widely used for the taxation of small business entities in many countries. Some surveys (where modelling is used taking into account the expenditures on auditing and possibilities for evasion from profit tax) show that the taxes on imputed income can be sufficiently effective and be combined with the general taxation system (see, e.g., [7], [4]).

For the imputed taxes the submission of reports is not mandatory. At the same time, one should make provision for the storage of primary documentation necessary, for example, for monitoring of correspondence with the established criteria, adjustment of payments and also for the cross-checks made by tax authorities.

The presumptive imputed taxes are set using two major methods of defining tax liabilities: *standard assessments* and *estimated assessments*¹¹ that significantly differ in terms of the regard of individual specifics of the taxpayers.

Standard assessments method was developed for the first time and applied in Israel since 1950's. Under the Israeli *tachshiv* system (*standard taxation*) careful examination of about one hundred sectors of business is made on the basis of *key indicators*, i.e. production factors. The average return and its interrelation with some factors are discussed with the representatives of the respective business sector. Unlike the *forfait*, which sets forth limits on the turnover, *tachshiv* does not establish such limitations.

The examples of the key indicators in *tachshiv* are: location; number of seats (for restaurants, cafes, hairdresser shops, etc.); qualification level of employees (for garages or carpenter shops); the nature of the used equipment (for truck and taxi drivers); water consumption (for ice producers); quality of soil and average crop yield (for the agricultural producers).

The developed *tachshiv* system has been being established over some decades. The complex preparation and continuous updating of the *tachshiv* require significant time and effort which contradicts to the purpose of simplicity which is associated with the presumptive taxation.

As the practice has shown, the effectiveness of the application of this method decreases if the established charges are not reduced in accordance with the inflation , while

¹⁰See, for example: Myles, G. (1996) Public Economics, p.231; S.M.Movshovich, G.A.Bogdanova, M.S. Krupenin. Ratsionalizatsiya struktury nalogov v perekhodnoy ekonomike Rossii. Rossiyskaya Ekonomicheskaya Shkoal, Moscow, 1997. The notes are made according to [7].

the assessments of the average income are not reviewed periodically. Besides, standard assessments do not take into account the specific conditions of the taxpayers, family status type, or losses in the particular year.

Nevertheless, the special tax treatment based on the *tachshiv* is used in such European countries as Greece and Turkey and in Latin America – in Bolivia, Mexico and Uruguay.

Estimated assessments method implies participation of the tax administration in the assessment of incomes and tax liabilities of the taxpayers. That method is most relevant for the sectors and types of business activity, where understatement of income is regular and wide spread. However, the practice has shown that discretionary treatment (establishment of tax liability upon discretion) often backfires by becoming an “invitation for corruption” for tax authorities [11].

Some examples of imputed taxes from the practices of different countries are provided below.

In **Greece**, resident and non-resident shipping companies are charged the ship tax that replaces corporate income tax for the part of the profit from shipping operations. Tax liabilities depend on the age and tonnage of the ship ([10], p.155).

In **Netherlands** in 2001 a reform of taxation took place with regard to wealth and capital income. Property tax, the tax on interest gains, dividends and a number of other types of income were replaced by the single tax on the imputed income from wealth. The imputed income from all assets is established on the level of 4% and thereafter charged with the tax with a fixed rate of 30%. As a result, the tax rate of 1,2% is applied to the to value of assets ([10], p.197).

The attempt to take into account the different earnings from different kinds of business activities was made in Bulgaria, where 43 kinds of the activities have been identified. Because the potential earnings of each business sector depend on the location of business, the country was divided into nine zones (out which four where in Sophia).

Taking into account the zoning, over 300 tax rates have been established, which in addition to that should have been reviewed on the regular basis. The system came out extremely entangled, contradictory and, by far, not fair. For example, the tax rates for some kinds of the activities differed significantly according to the zone and contradicted to the “common” idea of the profitability of this or that kind of business.

Ukraine. Single tax for natural persons.

The single tax can be chosen by natural persons registered as single entrepreneurs.¹² The single tax replaces VAT (at the taxpayer's choice), income tax for natural persons and the charge for mandatory state pension insurance¹³, mandatory social security charge and a number of other taxes.

The single tax may not apply to:

- business entities having purchased a special trade patent;
- natural persons paying a fixed tax according to the Ukrainian law;
- natural persons acting as single entrepreneurs, involved in trade of goods subject to excise tax (except for catering business).

The following conditions should also be met:

- number of hired wage earners (including entrepreneur's family members) over the calendar year should not exceed 10 persons;
- the annual receipt volume should not exceed 500 thousand grivnyas.

The actual tax rate is established by local authorities at the place of the taxpayer's registration. The amount of tax is from 20 to 200 grivnyas per month (depending on the kind of the activity). If the taxpayer indicated several kinds of business activities in the application, the highest single tax rate among those kinds is applied.

If the payer of the single tax is engaged in business activities using hired labour or his family members are taking part, he is obliged to pay up to 50% of the tax rate for each person.

The income gained from business activities is not included in the total annual income of such taxpayer and the persons who are maintaining work relations with him.

The accounting and reporting are made as simple as possible (with the exception of the accounting related to charges withheld to the pension fund from hired workers and payments to other social funds). The taxpayer can become the payer of VAT and maintain respective bookkeeping.

Imputed taxes based on indicators became popular in the countries with economy in transition. This kind of presumptive taxes are slightly better evaluating the potential income of small enterprise compared to simplified taxes based on the receipts or gains.

¹² It may be noted that, unlike the Russian single tax on some activities the Ukrainian one is not mandatory (i.e. the taxpayer can choose between the payment of single tax and general tax treatment).

¹³ However, according to the "Conclusive provisions" of the Law # 1058, as of January 1, 2004, the entrepreneurs having chosen the special treatment and members of their families taking part in the business shall pay fixed-amount charges to the Pension Fund.

However, a conflict of interest can be found within such special treatment schemes. Thus, the task of taxing potential profit is contradiction with the task of designing a simple and transparent tax system. As a result of searching for the acceptable balance between the former two tasks the systems of imputed taxes in the countries with economy in transition become too complex or not adequately differentiated by the kind of the activity.

The system of imputed taxes (unlike simplified taxes) is bound to create detailed lists of the types of businesses it covers. That, in turn, leads to continuous discussion in view of the desire of some entrepreneurs to switch to general treatment mode and the desire of others to become subject to special tax treatment. [5]¹⁴.

Along with the complexity, difficulty and unreliability of assessing the sectoral activity by key indicators, still other negative consequences of the application of taxes on imputed earnings should also be mentioned here. Because the target of taxation is not the actual income but a certain estimate of the production factors, small business entities may lose incentives to increase the number of employees and involved capital, seeking rather to reduce their tax liabilities.

The applied methods of assessment on the basis of key indicators involve expert evaluation of profitability. Such “discretionary assessments” may encourage the corruption in tax and state authorities having to do with the establishment of tax liabilities.

2.4. Patent form of taxation

The patent fee is a form of imputed tax. The patent form of taxation is applied for the most part to small business entities, natural persons and micro-enterprises .

The cost of patent may depend on the sector or kind of business, and, as a rule, does not depend on the size, location or turnover of the business entity.

In **Lithuania** a special tax treatment is applied on the basis of *business patents* for entrepreneurs who are natural persons [6]. That treatment covers:

- 25 kinds of industry and commerce (including tourism and crafts);
- 13 kinds of services (for example, hairdresser’s and photographer’s services);
- 6 kinds of trading activities (including selling at the stalls, from mobile vehicles and trays);

¹⁴ For example, in Bulgaria it has been long debated why the doctors are eligible for imputed tax, while dentists are not. That given the fact that categories of businesses under the system introduced in 1998 have been reviewed almost every year [5].

- some other activities (translation of texts, provision of machinery for computer games, professional sports, etc.).

The range of charges is installed by law on the state level (from 100 to 6 thousand lits per year). Local authorities establish specific size of the payment for the taxpayers registered in the region.

In order to receive a patent the taxpayer submits to the local tax authorities:

- personal identification documents (also for his family members he wants to include in the patent);
- to photographs;
- hygienic certificate (for the activities related to foodstuffs, cosmetics, toys, etc.);
- data about the receipts for the past tax period;
- documents confirming the payment of social fees.

If the receipts of the taxpayer over the entire period of the respective activity during the patent term exceeds 100 thousand lits, additional patent fee is charged (up to two patent payments). Next time when the taxpayer would like to receive the patent, the payment will be doubled automatically.

The taxpayer holding a patent for commerce or trade should maintain accounting and retain the payment documents for the tax inspection. The VAT payers should also retain copies of the VAT invoices.

Ukraine. Fixed tax paid through though purchasing a patent .

This kind of taxation of income can be chosen by individuals registered as single entrepreneurs and trading in goods (except for liquor and tobacco products), and providing additional services in the marketplace related to such trade and being subjects to the marketplace tax.

Other eligibility limitations for the fixed-size tax (FST) include:

- number of hired workers not exceeding five persons (including the entrepreneur's family members);
- gross income from the business activities over 12 calendar months preceding the purchase of patent does not exceed 7 thousand times tax exempt minimum income of citizens.

The FST is established by the local council depending on the location of the site where trading is performed in the amount of 20 to 100 grivnyas over the calendar month. The fee for entrepreneur activities in the entire territory of Ukraine is 100 grivnyas. If hired workforce is used, the size of tax is increased by 50% for each person. The patent is issued for the period from one to twelve calendar months upon the FST payer's option.

FST relieves the taxpayer (as well as the persons maintaining employment relationship with him) from the following taxes:

- labour remuneration charges;
- craft tax;
- mandatory social insurance charge;
- need for trade patent purchase.

The FST payer is not relieved from the obligation to assess, withhold and transfer to the public sector the income tax on the income paid to the hired workers. The amount of the income gained from business subject to FST taxation is not included in the annual total revenue.

The FST payer is relieved from accounting of income and expenditure. The activities by FST payers and the persons maintaining work relations with them and take part in such activities are not subject to licensing.

Ukraine. Trade patent.

The trade patents are purchased by:

- legal entities involved in the following activities: wholesale and retail trade; provision of home-based and household services; exchange of foreign currency; gambling business;
- natural persons involved in the wholesale or retail trade outside the marketplace and provision of home-based or household services.

The cost of the trade patent for trading or services is established by the local self-government within the range from 30 to 320 grivnyas depending on the location of the point of the distribution and list of goods.

The cost of patent for a currency exchange office is 320 grivnyas.

For gambling businesses the cost of patent is calculated per the number of slot machines and gambling tables.

The trade patent does not substitute other taxes. However, its value is subject to subtraction from the profit tax. Thus, the trade patent is at the same time *an alternative minimum tax*, which the taxpayer must pay regardless of the profit.

2.5. Minimum taxes

Minimum taxes are considered a promising kind of presumptive taxation.

In a number of countries minimum taxes are established regardless of the level of income or type of business of the taxpayers. In other countries that apply such taxes,

relatively low shares of turnover or assets are established as the rates. They are thus becoming a version of the imputed or simplified taxes described above.

In the '60s and '70s minimum taxes have been actively used by French-speaking African countries for establishing *minimum taxes on corporate income*.

Five options for minimum taxes were applied [11].

For example, in Benin and Cote d'Ivoire the fixed payments set were identical for all corporations regardless of their size and production output. In Equatorial Guinea, Malawi and Senegal the payment scale was graded depending of the turnover in all of the aforementioned countries the minimum tax had regressive nature.

In yet other countries (Chad, Ghana, Guinea, Niger, Sierra-Leone, Togo) a kind of minimum tax was introduced that was assessed in percents of gross income or turnover (from 1% of the turnover in Niger to 5% in Ghana).

The third option established a certain fixed payment added with a percentage of gross receipts (Madagascar).

The fourth version presupposes that the corporations pay the larger of two taxes established in the absolute figures and in percentage of the gross return (Burkina-Faso, Cameroon, Central African Republic, Comoro Islands, Congo and Gabon).

Finally, the fifth, most complex version is used in Nigeria, where the tax liabilities are determined according to the maximum value of the following indicators: 0,5% of the gross return; 0,5% of the value of net wealth; 0,25% of paid-capital; 0,25% of the turnover.

Starting with the second half of the '80s, many Latin American nations upon the recommendation of the IMF introduced minimum taxes on the basis of assets. Those taxes were intended for fighting understatement by corporations of the accounting data on profit and the practice of transfer pricing by the international corporations.

In 1986 **Bolivia** has introduced the tax on equity capital at the rate of 3% as a form of presumptive taxation. That case is fairly unique since in Bolivia there used to be other tax on corporate income. Such tax was also introduced thereafter, while the simplified tax became a minimum one alternative to the corporate income tax [14].

Minimum taxes where the tax base is based on gross assets are used in **Argentina**, **Nicaragua** and **Ecuador**, and, on net wealth, in **Columbia**.

In 1989 in **Mexico** a presumptive minimum tax was introduced on the gross corporate assets at the rate of 2%, while in 1997 the tax rate was reduced to 1,8%. It implies the application of deductions from the gross assets of resident companies with the exception of

financial institutions. With respect to the latter, minimum tax is not applied [12]. The results of the application of the tax are considered favourable [14].

In **Peru**, minimum tax based on gross assets in 1999 was replaced by a scheme of prepaid income tax, where the payments are determined on the basis of two values: progressive tax on net wealth and fixed share from the income of the previous year [9].

Minimum taxes are applied also to small business entities in the form of minimum personal taxes. The tax is established in the form of an absolute sum or in percents from the turnover or gross profit.

In **the US**, *alternative minimum taxes (AMT)* have been applied for over thirty years for the taxation of corporate and individual income. In the US, AMT are not presumptive taxes, however, their purpose complies with the general concept of minimum taxes [14]. In the US as well as in Canada, Denmark and Norway, AMT is accrued on the basis of the income and takes the form of the established deductions [9].

The need to collect both regular taxes and AMT complicates the taxation. As to the US and Canada, some surveys point out that even under a well-developed system of tax administration the use of AMT, probably, is not compensated by additional proceeds [1].

In **Germany** in 2005 a minimum tax was introduced in favour of the copyright holders in the amount 12 Euros that will be charged from each sold computer. Thus Germany became the first country in Europe to charge the PC distributors with “preventive fines”, since the equipment may be potentially used for the violation of the authors’ rights. It is planned that the funds thus collected will to some extent reimburse the copyright holders for the damage caused by the pirates¹⁵.

The main idea underlying the introduction of minimum tax with regard to medium and large business entities is to guarantee certain minimum tax gains regardless of the declared loss, the use of preferences or “creative” accounting.

Alternative minimum taxes based on the combination of gross assets and turnover (receipts) could become a good way of taxing the income of small and medium enterprise. The production sector is likely to have a large amount of gross assets compared to the size of business. However, the service sector may have a relatively small amount of assets, but a large volume of turnover. Thus, the proposed combination of indicators for the accrual of AMT should work well for both sectors. The AMT rate should be established in accordance

¹⁵ <http://news.proext.com/comp/15766.html>

with the smallest corporate income tax rate on the basis of the presumed reasonable capital return rate [9].

Minimum taxes are quite effectively preventing tax evasion by the registered taxpayers including through understatement of profit by companies using transfer pricing. However, they create the tendency of “freezing” the companies’ tax liabilities. Inclusion of minimum alternative taxes in the simplified tax systems essentially complicates those systems and adversely affects the willingness of the taxpayers to their responsibilities. [1].

2.6. Presumptive withholding taxes

A kind of *presumptive minimum taxes* are *the taxes withheld at source* (hereinafter *withholding taxes*).

Withholding taxes are collected in the form advance payments, which are usually withheld from the profit of the supplier company on account of the profit tax of the buyers of its products. In relation to non-registered business entities such taxes are final. Withholding taxes are, as rule, applied when the company’s partners belong to the so-called «hard-to-tax» sectors, such as, e.g., retail trade.

For example, in **Benin**, the withholding tax on profit applied on the level of a beer brewing plant usually provided for significant proceeds, while it is traditionally hard to collect tax from beer distributor companies.

Essentially, other taxes can also be withheld at source (including VAT, excises, integrated social tax, income tax on natural persons). For example, according to the scheme of withholding at source, taxes could be collected from public institutions purchasing goods and services from private suppliers [11]. However, withholding taxes do not enable identification of the companies purchasing products from the “primary” enterprise ([3], p.13).

The *presumptive taxes on imports* presented below can simultaneously act as a kind of minimum taxes and a version of *withholding taxes*.

2.7. Presumptive taxes on imports

The presumptive taxes on imports are used to gain proceeds from both registered and unregistered importers.

For those importers who are not registered as such with tax authorities this tax is flat, (i.e. its payment is final). At the same time, for registered importers the payment of the tax is set off at the conclusive stage of the tax settlements, for example, on the profit tax¹⁶. If the advance payment does not exceed the accrued amount of the profit tax, the taxpayer gets reimbursement.

Following the IMF recommendation, some African and Latin American countries started to apply these taxes. The tax rates may be differentiated because there exist two target groups.

For example, in **Comoro Islands**, the value of goods imported by the unregistered businesses is taxed at the rate of 5%, while for the advance tax payments by registered importers the rate of 1% is applied. Such a significant difference in rates should serve as an impetus towards registration for the importers. However, even without the differentiated rates, the impact on the importer can be sufficient, if the accrued charges exceed regular tax liabilities.

In **Ethiopia** a minimum tax on imports was introduced that was limited in scope to the area of the Addis-Ababa airport. Registered importers were relieved from the tax. Potential income of the unregistered importers was evaluated by the customs officers and taxed at the rate of personal income tax. It was planned to subsequently extend the effect of the tax for the entire territory of the country. The results of the Ethiopian experiment were the following: taking into account relatively easy collection, the proceeds tripled in approximately three years [11].

From the point of view of tax administration, the presumptive tax on imports provides for relatively quick and guaranteed proceeds. The size of advance payment should be, on the one hand, large enough so that the taxpayers would not ignore its reimbursement. On the other hand, it should not be too large compared to the potential profit of unregistered importers (the risk of excessive taxation).

It should be also taken into account that advance payment of the presumptive import tax by increasing the real rate of the customs tariff also increases costs and extra difficulties for the registered importers.

¹⁶ In some countries pre-payment of presumptive taxes on imports is subject to subsequent subtraction from different taxes including VAT. However, for example, the practice of Cot d'Ivoire has shown that the set-off mechanism was virtually unmanageable because of its complexity ([3], p.13)

3. INDIRECT TAX LIABILITY ASSESSMENT METHODS

3.1. Conditions for indirect assessment of income

As it was mentioned before, presumptive taxation includes indirect methods for the determination of tax liabilities alternative to the methods of assessment on the basis of the taxpayers' accounting. Indirect methods are applied when it is impossible to determine the real income for the reason of missing accounting reports of the taxpayer or if the accounting data provided is obviously inadequate.

The conditions for the application of indirect methods are laid down in the national tax laws.

For example, in **Germany** indirect assessment of income can be applied if the taxpayer does not provide the requested confirmations of the data indicated in the declaration (if on the basis of the available documents it is impossible to reliably determine the real income). Then, the tax authority communicates to the taxpayer the officially calculated tax that can be contested within one month.

In **France** the utilised system is called *taxation d'office*, or income assessment. It is applied if the taxpayer did not submit the tax declaration on time and has not reacted within 30 days to the requirement to submit one, or in the event of non-responding to the enquiry by the tax authority, or hindrance to the tax inspection. The tax authorities assess the taxable base using the available information and send a notice that can be contested by the taxpayer only in court. The taxpayer should be notified about the rationale behind the assessment of his income at least 30 days before the tax collection procedure begins. The time limitation for the application of this assessment procedure with regard to the income tax and VAT is three years.

In **Greece**, the individual income tax can be adjusted if the amount of income determined by methods of indirect assessment exceeds the declared amount of income and the taxpayer is unable to explain the difference. The income is assessed according to the following approximate set of indicators: rent for the second housing accommodation; maintenance costs of transportation means; expenditures on the household service staff; purchase and construction of realty (excluding the primary housing accommodation with an area up to 120 sq. m.); moveable property (automobiles, watercrafts, aircrafts); purchasing of securities.

In the **United Kingdom** tax authorities can resort to indirect methods in case of fraud or if the inspector has not received a complete information about the income over the last twenty years.

In **Argentina** the respective procedure is called *determinación de oficio* and is applied if the taxpayer was not capable of maintaining accounting or if his declaration raises doubts.

In **India** indirect methods of assessment are applied in cases when the taxpayer was not capable to maintain accounting or did not do it on a regular basis, and if the taxpayer's reporting was incorrectly drafted or incomplete.

Ukraine became one of the first countries with economy in transition to introduce indirect tax liability assessment methods.

The main grounds for the application of indirect methods by the tax authorities are the following:

- it is impossible to determine the amount of tax liabilities because of the lack of necessary documents;
- the data quoted in the tax declaration are not confirmed by the available accounting documents.

The application of indirect methods covers legal entities, their affiliates, branches, and other separate units having no status of a legal entity and natural persons acting as business single entrepreneurs.

The indirect methods can determine the amount of tax liabilities with regard to major tax payments, including VAT, corporate profit tax, individual income tax (on physical persons acting as business entities) and excise fees.

The tax liabilities of a taxpayer are indirectly determined by the following methods:

- economic analysis;
- assessment of proceeds;
- monitoring of income and expenditure of natural persons acting as business entities;
- analysis of the taxpayer's income and expenditure information.

Below we describe the methods presented in the Ukrainian Methodology Recommendations and some other methods of the indirect assessment of the taxable base. Those methods are for the most part targeted at preventing the understatement of tax liabilities by the large and medium companies working in the framework of the general tax treatment.

3.2. Method of economic analysis

The method is based on the interrelation and interface of different economic indicators (gross income, gross expenditure, etc.), describing the taxpayer's economic activities and are meant for the assessment of the following elements of the tax base:

- volume of output and distribution of goods (works, services);
- material and immaterial costs;
- growth of the taxpayers' assets;
- labour costs ;
- gross income and gross expenditure;
- volume of distribution and procurement of products.

The basis for the assessment of the elements of the tax base is the determination of the actual volume of production output and the costs incurred in that process.

The method of economic analysis is an advisable means for assessing tax liabilities of the retail and catering businesses as well as some other categories of small and medium enterprise working with cash on hand. This method provides rationale to determine gross income of the taxpayer and taxable base for the collection of profit tax, VAT and excises.

3.3. Cash proceeds method

This method is based on the assessment of income gained by the taxpayer from the economic activity. In order to determine this indicator, the information about the transfer of funds to the taxpayer's bank account and other information confirming the receipt of the funds by the taxpayer is used.

3.4. Method of analysing information about taxpayer's income and expenditure

This method is based on the evaluation of elements of the taxable base that are different from the one handled by the economic analysis and cash proceeds assessment methods. These other elements and sources for their identification include:

- income of other persons that are active in the identical or similar environment with the taxpayer;
- comparison of the taxpayer's expenditures with his income¹⁷;
- quantitative and qualitative composition of the taxpayer's clients and the sustainability of the demand;
- other objects, processes and phenomena, information and data that are the evidence of the taxpayer's tax liabilities.

¹⁷ I.e., the essence of the method consists in defining the taxpayer's income as at least the amount equal to his expenditures. This is logical, however, not correct, because identifies only part of the income. This method is currently used in Estonia, but has been cancelled in Germany and France [15].

The information obtained from third persons who have not had direct financial relations with the inspected business, but indirectly determined the taxable base, can be used in this context. For example, the basis for the calculation of gross income of the enterprise providing transportation services and other services can be natural indicators (weight, cubic metres, number of pieces, etc.).

Another option for the application of such method (by comparing the taxpayer's income and expenditures) is recommendable for assessment of the tax liabilities of retail trade and catering, as well as some other kinds of small and medium enterprise working with cash on hand.

The basis for the third kind of this method's application is establishment of the amount of receipts over a certain period and applying that to other periods. Such method can be applied to small and medium enterprise including self-employed natural persons active in retail trade and services.

3.5. Statistical methods

The statistical methods are based on the study of massive statistical regularities. This method can give a very precise assessment of the clandestine production activities, i.e. the activities performed on a legal basis, but not declared.

Method of specific indicators is connected with the use of a single indicator reflecting the level of economic activity. This method implies utilisation of special surveys, questionnaires and inspections and analysis thereof for the establishment of divergences between the income and expenditure of individual groups of taxpayers, along with the description of some aspects of the shadow activity and its assessment according to a certain group of economic parameters. Below, the different versions of this method are described:

Bank deposit method is based on the idea that all the receipts on the taxpayer's accounts in domestic and international banks are income. Depending on the ways and nature of handling of financial and commercial transactions by the taxpayer, the assessment of the income done through this method can be significantly underestimated or exaggerated. The method is not effective in those countries where cash on hand and barter are widely used.

Method of the flow of goods consists in identifying the flow of goods for the most important products and groups of goods. The purpose of the method is development of the specific balance model and detection of weak points in the existing information database.

For example, if for a certain kind of goods the production output and imports are small than the total utilisation rate, then it is necessary to decide which part of data (the one on production or on imports) is more reliable.

Employment indicator method (Italian method).

The Italian statistical service, ISTAT, is currently the most highly regarded one worldwide in terms of the detection of concealed income. The Italian statistical staff focused primarily on the survey of the workforce inputs. Primary data is received through specially organised survey of households selected on a random basis. The questions asked during the survey are related to the number of hours worked by the respondents in this or that sector.

The advantage of such approach consist in the fact that for the people who are not being questioned about their income it does not make sense to conceal or distort the information about working time. The information is thereafter converted into man-days by economic sector. When the tax authorities are using this general data categorised by sectors, the deviations become apparent between the monitored enterprise and statistical data.

3.6. Method of special estimated indicators

By *special estimated indicators* the analytical indicators are implied, which are calculated on the basis of the reporting data or other information sources in order to reduce or rule out the impact of the factors related to concealment of income. The application of the method is based on the following underlying assumptions:

- it is possible to identify an indicator that would definitely change under the influence of income concealment;
- it is possible to calculate the value of such indicator for the conditions of a normally working enterprise.

The discrepancy between the actual and standard value of the indicator may be connected with the concealment of income.

The German federal statistical authority is performing on free and representative basis the quarterly calculations of the structure of different groups of population including representatives of free trades. Such data is used as key figures in the course of monitoring the economic operators.

3.7. Method of stereotypes

The method issues from a holistic approach to the concealment of income as a totality of actions and processes organised in certain way. The method of stereotypes is designed to detect unusual dependencies between economic indicators that reflect the internal structure and external connections of the criminal event (concealment of income) and are met rarely in the usual framework of economic activity.

A popular and wide-spread application of this idea is the method of “red flags” or indicators that signal about the possible violations and abuses.

For example, the indicators of a crime such as kiting (issuance of cheques against an uncollected amount) are:

- frequent issuance of cheques ;
- frequent drawing of cheques in the same name to the accounts with different banks;
- frequent requests by the depositor to check his balance.

3.8. Net property value assessment method

This method (referred to in different sources as the method of the assessment of fixed capital and net capital) is an efficient means of detecting shadow cash and concealed income of the taxpayer. A specific feature of this method is the fact that no checks of the accounting are required for the detection of concealed income and identification of the amount of profit.

The method is based on the assumption that increase of the taxpayer’s means over the certain period of time can only take place through the revenues, which are subject to taxation, non-taxable incomes and singular cash proceeds, provided that there have been no settlements of private nature (gifts, satisfaction of vital needs, etc.).

If the calculation has established that the property gains and personal consumption taking into account certain accruals and assignments exceeds the income from which the taxes have been paid, it means, that the property gains do not relate to the declared income and therefore are of an illegal nature.

As a rule, the analysed period lasts at least for three years.

If it is impossible to document the consumer expenditures, the information about subsistence wage and average household spending is used. Such information is regularly published in developed countries by the government statistical services and collected on the basis of representative and voluntary surveys of households.

3.9. Cash deficit calculation method

This method of checking the money turnover can be used in the course of the check-out of small and medium enterprises which receive cash on hand at the cash desk, which is entered in the cashbook.

The basis for the calculation of the cash deficit is the fact that the owner cannot hand out more money than is available at the cash office. If the expenditures over the certain period exceed the amount of cash and proceeds of cash over the same period, it is an evidence of cash deficit and may serve as grounds for further more careful inspection of the business.

3.10. Cash flow calculation method

This is a of property gains calculation method. The cash flow calculation method limits itself to the income and expenditure analysis. There are two exist two kinds of the cash flow:

- calculation of the total cash flow, covering both business and private life;
- cash flow estimation taking into account only business or only private proceeds and payments

The main idea of the cash-flow method is that over the given period the taxpayer cannot spend or save more money than he has gained from revenues or other sources.

3.11. Method of reimbursement of costs

The actually made cash payments are compared with the amounts of money the inspected person has had. This method is a simplified version of the cash flow method. When calculating the reimbursement of costs also those funds are taken into account, which the taxpayer gains from other sources than official employment.

The method is used when adequate information is available about the property status of the taxpayer.

3.12. Method of correcting indicators

The method consists in the comparison of the economic indicators with factors of the external environment where the company is functioning.

As an example, one can draw the comparison between the dynamics of the volume of sales of a certain kind of goods by some enterprise and changes in the market prospects for the same product. For example, the significant growth of distribution in the conditions of

decreasing demand requires investigation. This method can be used while comparing the prices and tariffs used to sell the goods with the average market prices.

CONCLUSIONS

International experience of special tax treatment application: general conclusions

On the basis of the international experience we can make some conclusions allowing to assess the status and prospects for the application in Russia of certain options and methods of presumptive taxation. Not only positive, but also negative international experience is helpful since it enables learning on the mistakes of others.

The international experience shows that special tax treatment contributes to the expansions of the taxation network and encourages reduction of non-registered economic activity¹⁸. They are more acceptable for the small enterprise compared to the general treatment.

However, simplification of the taxation and reduction of administrative costs (incurred by both small business entities and tax administration) is often not achieved. The main reasons are lack of clarity with respect to the definition of the taxpayer categories and incoherence of presumptive taxes on various parameters both between each other and with the general treatment schemes¹⁹.

Those shortcomings related to the establishment and functioning of special tax treatment are common for many countries and also typical for Russia.

It should be also mentioned that the chosen system of presumptive taxes meant designed to solve a narrow scope of problems is likely to be useless for the solution of other tasks. Therefore, the starting point in developing the system of presumptive taxation should be to identify and designate purposes and priorities to be taken into account in the framework of the tax legislation.

The international experience shows that the efficiency of application of presumptive taxation depends to a great extent on the state of the database, regulation of the accounting and calculation procedures and the quality of tax administration.

The problems of thresholds and rates

¹⁸ According to some estimates, the introduction of presumptive taxes in Ukraine led to reducing the size of shadow economy by 11-14 % throughout 1999-2000 (see, e.g., [1], [5]).

¹⁹ The system of presumptive taxes effective in Ukraine is a example of lack of coordination between different taxes. Thus, natural persons involved in business in the service sector and having annual return less than 119.000 grivnyas, may choose between three presumptive taxes: single tax, fixed tax or trade patent. Many small business entities may choose between two taxes: single tax and fixed tax. The Ukrainian approach is excessively complicating the tax system and reduces general proceeds from this sector of the economy.

In many countries special tax treatment provides for two-level limitations (thresholds) for the taxed entity that are usually expressed in turnover indicators. Below a certain level the object is relieved from tax. Above the other established level the object is taxable according to the general treatment scheme. Between those levels the object is covered by the special tax treatment.

If the threshold where the special treatment ends is set too high, too many economic operators will use such treatment to reduce their taxes. On the other hand, too low “exit” threshold complicates the activities of small business entities, for which accounting and reporting poses a serious problem.

The issue of thresholds and rates is, as a rule, aggravated in the event of lack of differentiation of taxpayers by the kind of activities and sector, as well as the size of business. Consequently, the horizontal equality of tax treatment is violated, while at the same time high and even restrictive barriers are set for legal entrance into the market of the new economic operators.

Differentiation of the thresholds and rates on the basis of the respective classification of taxpayers is necessary for countries like Russia, where extremely high regional and sector-specific differences of the key economic parameters are the case. At the same time it is clear that excessive complication of the configuration of presumptive tax system generates problems that are even more aggravating for the tax system as a whole.

Prospects for the development of presumptive taxation in Russia

Simplified tax treatment

In the Russian context we deem it appropriate that the simplified taxes are differentiated by the larger types and sector of business activity.

It would be also appropriate to introduce the classification category of a “micro-enterprise” defined in accordance with a relatively low level of turnover or income. For micro-enterprises and natural persons acting as single entrepreneurs, who fit within the established threshold limits and do not qualify for the single tax on imputed income, the choice should be given to either use *simplified tax system* or make their business *patent-based*. The cost of patent could be determined by the kind of activities and number of hired workers.

The implementation of the above proposal will make the structure of simplified tax system more complex. However, it would not create extra difficulties for the activities of

small enterprises and tax administration. The level of both vertical and horizontal equality of simplified tax system would improve.

The simplified tax system currently includes minimum tax. The experience of other countries shows that the extra costs associated with the accrual of alternative minimum tax are not covered by the tax proceeds. In Russia, such comparative assessment was never made, however, alternative minimum tax definitely complicates the usage of simplified taxation.

In Russia, artificial division of companies for the purpose of transition to the single tax collected in the framework of simplified tax system is observed.

The formal split of companies enables one to use different taxable bases: income (at the rate of 6%) or income minus expenditures (at the rate of 15%). As a result the rate applied to the “income minus expenditures” basis under the simplified taxation system turns out to be lower by nine percentage points than the profit tax rate under the general taxation treatment. It can also be mentioned that the threshold of 15 million roubles annually that makes one eligible for simplified taxation is relatively high according to the international standards[1].

In the developing countries that actively use presumptive taxes, programmes for conversion to general tax treatment are usually not envisaged.

Meanwhile, Russia’s fundamental difference from the countries of the developing world is the education level of its population. The simplified tax system should serve as an “elementary school” for taxpayers as it is a custom (or as it is pursued as a goal) in the developed countries. As they are acquiring experience, small business entities should convert to general tax treatment.

One can, for example, introduce limits on the number of years during which the taxpayer can enjoy special tax treatment, or use the French experience, whereby the upper limits on the income or turnover have not been not indexed²⁰. Another way to make excessive numbers of taxpayers “leave” the special treatment is gradual increasing of rates (starting with the second or third year of operation) up to the level when it becomes not

²⁰ In France, the value of the upper threshold for the *forfait* did not go through indexation. Respectively, along with the growth of prices induced by inflation many small business entitles have “automatically” left the special treatment. In the general case, however, the upper and lower value limits should be indexed in accordance with the inflation to maintain the integrity of the tax system (see, for example, [1, g]).

lower than the regular taxes, which it replaces²¹. The increase of tax burden should be accompanied by a set of measures for the support of small enterprise including protection from all forms of the criminal or administrative racketeering.

The simplified taxes using turnover indicators as their taxable base can be quite easily eliminated from the tax system. Nevertheless, the taxes on imputed income are not easily convertible into general tax treatment.

Single tax on imputed income for certain kinds of the activities

The results of application of the tax treatment in the form of single tax on imputed income (STII) for certain kinds of the activities cannot be evaluated unequivocally. The correct approach would be to gradually expand the list of activities eligible for STII.

However, the imputed income is essentially determined at the discretion of regional authorities. As a result, one finds unjustified differentiation of payments imposed on different taxpayers²². In the event of excessive rates the entrepreneurs, who have no right to reject this taxation approach are faced with the choice of either keeping a loss-making operation or closing down their business (or doing it illegally).

It is therefore required to clarify the range and levels of basic return indicators and procedures for applying correction coefficients.

Because of the specific features of the types of activities qualifying for STII, the frequently proposed refusal from mandatory application of this treatment is not a realistic solution. At the same time, small business entities involved in respective activities and meeting the threshold limitations for micro-enterprises described above should be given an opportunity to use patent taxation.

The proposed extension of the patent-based entrepreneurship to cover relatively small-size operations means an attempt of a kind of *convergence* between the two kinds of presumptive taxation existing in Russia. As a result, foundation will be laid for the achievement of better coherence within the system of presumptive taxes in general. It should be also mentioned that both the proposed patent form of taxation and the existing simplified taxation system are based on the method of *standard assessment*. As to the single

²¹ Determination of the level of tax rates may be based on the IMF survey made in Ukraine according to which a 10% rate of a single tax on gross receipts (including VAT) is to preferential [5].

²² The competencies of regional authorities have currently become somewhat more restricted. Firstly, they can introduce or cancel the tax on some activities within the framework of the federal list. Secondly, they can reduce the amount of tax within the certain limits by establishing the reduction coefficient.

tax on imputed income, it is based on the method of *estimated assessment* with a relatively high degree of discretion (= arbitrary action) of the local authorities.

Other kinds of presumptive taxes

Relatively new and promising kinds of presumptive taxes are the minimum taxes, import taxes and withholding taxes. In this context, minimum taxes can be viewed as an effective component of the tax system rather than a transitional form of taxation.

As the international experience has shown, for the minimum taxes applied to medium and large companies the most suitable taxable base is the value of assets. In Russia at the present time it is hard to achieve market-based assessment of assets for most companies. However, taking into account the development of the stock market and the forthcoming replacement of the property tax by real estate tax it would be worthwhile to consider the option of introducing alternative minimum taxes for certain sectors of the economy.

Thus, alternative minimum taxes that establish an effective barrier on the way to tax evasion by large corporations and transfer pricing can be in the first place applied to oil companies.

The “useful properties” of the presumptive taxes on imports and withholding taxes appear quite obvious. One can just mention that the taxes on imports should be introduced simultaneously with the reduction of the average import tariff rate.

Indirect methods for the assessment of tax liabilities

The legislation of a number of foreign countries provides for and regulates the application of the indirect methods for the assessment of taxpayers’ liabilities²³. Those methods are intended for the most part for identification of the understated tax liabilities within the framework of general tax treatment. Indirect methods and the conditions for their application are partially described in Section II of the current paper.

The availability of indirect methods in the toolkit of tax authorities and the threat of their application is a powerful containment factor against aggressive tax evasion. At the same time, indirect methods can become a sort of mass destruction weapon in the hands of

²³ The government of Russia in 2001 has discussed the issue of developing methodological guidelines and relevant legislative provisions for the application of indirect tax liability assessment methods. Also under development were the amendments to the Tax Code concerning monitoring of expenditures that would allow the tax authorities to accrue extra income tax on the taxpayer’s income on the basis of his expenditures (see, e.g., *Kommersant Daily* of 4 August 2000)

the tax authorities²⁴. Abuse of those methods should be prevented, in particular, by means of giving the taxpayers adequate means of defence.

It is clear that different indirect methods can lead to sufficiently different assessments of the tax liability. Therefore, for example in the Ukrainian Methodology Recommendations is proposed to assess the taxable income by several methods. Besides, if the tax authorities observe the conditions for the application of indirect methods, the taxpayer has the right to refuse to acknowledge the accrued taxes. In such case the tax authorities should prove the relevance of additional accruals in court.

It appears, however, that for a “symmetrical answer” the taxpayer should have the right of presenting during the court hearing his own assessments made on the basis of one of the approved indirect assessment options.

²⁴ In Ukraine, in connection with the unclear wording in the legislation with regard to the conditions stipulating the use of indirect methods, concerns were raised about possible arbitrary actions by the tax militia. The practice proved that those concerns were justified.

Bibliography

- [1] Bird R., Wallace S., "Is it really so hard to tax the hard-to-tax? The context and role of presumptive taxes", Andrew Young School of Policy Studies Georgia State University, Stone Mountain, Georgia, May 15-16, 2003.
- [2] Byrne P., "Tax incentives for FDI in seven Latin American Countries", Georgetown University, June 2002.
- [3] Chambers G., Araujo-Bonjean C., "Taxing the urban unrecorded economy in sub-Saharan Africa", Communication for the "Hard to Tax" conference in Atlanta, May 2003, p.13.
- [4] Christian R. Jaramillo H., "Presumptive Income Taxation and Costly Tax Compliance", Department of Economics University of Michigan, March 19, 2004.
- [5] Engelschalk M., "Creating a Favorable Tax Environment for Small Business Development in Transition Countries", The World Bank, Washington, D.C.
- [6] Juzaitis D., "Small and medium enterprises. Overview of Special Tax Regimes", TACIS, Taxation Reform Project, Draft as of 24/11/00.
- [7] Marhuenda F., Vasin A., Vasina P., "Optimal choice of the tax system under tax evasion", Working paper #2003/040, Moscow, New Economic School, 2003.
- [8] Presumptive Direct Taxes,
<http://www1.worldbank.org/publicsector/tax/presumptivedirecttaxes.html>.
- [9] Shome P., "Tax Administration and the Small Taxpayer", IMF Policy Discussion Paper, Fiscal Affairs Department, May 2004.
- [10] "Structures of the taxation systems in the European Union, 1995-2002", European Commission, 2004,
http://europa.eu.int/comm/taxation_customs/resources/documents/structures_2004_final.pdf
- [11] Taube G., Tadesse H., "Presumptive Taxation in Sub-Saharan Africa: Experiences and Prospects", IMF WORKING PAPER, January 1996.
- [12] "Tax Law Design and Drafting", volume 1; IMF, 1996, Thuronyi V. ed, Chapter 12, pp.401-430.
- [13] Terkper S., "Managing Small and Medium-Size Taxpayers in Developing Economies", Tax Notes International, 13 January 2003, p.211-234.
- [14] Wallace S., "Imputed and Presumptive Taxes: International Experiences and Lessons for Russia", Working Paper 02-03, the Andrew Young School of Policy Studies, Georgia State University, March 2002.
- [15] Vakhitov, R., Repa, A. Kosvenniye metody opredeleniya nalogovogo obyazatel'stva. "Debet-Kredit" weekly, #36, 2002, Kyiv

[16] Vakhitov, R., Repa, A. O nepryamykh metodakh opredeleniya nalogovogo obyazatel'stva. "Debet-Kredit" weekly, #36, 2002, Kyiv

[17] Gorst, M. O roli malogo biznesa v sfere zanyatosti i o problemakh nalogooblozheniya subyektov malogo predprinimatel'stva. Analiticheskaya zapiska. Institut kompleksnykh issledovaniy, Moscow, 2004.

[18] The Law of Ukraine "On the patent basis for some business activities" of 23.03.1996 #98/96-BP.

[19] Metodika provedeniya analiza finansovo-khozyaistvennoy deyatel'nosti organizatsii, 1997.

[20] Metodicheskiye rekomendatsii opredeleniya summ nalogovykh obyazatelstv kosvennymi metodami. "Bukhgalteriya" newspaper, #36, vol. 1-2 of September 2, 2002, Kyiv

[21] Nyuansy nalogooblozheniya subyektov malogo pedprinimatel'stva Ukrainy. "Birzha" newspaper of 23 January 2001, Odessa

[22] Problemy nalogovoy systemy Rossii: teoriya, opyt, reforma. IEPP, Moscow, 2000

[23] Tax Code of the Republic of Kazakhstan, <http://www.keden.kz/zakonodat.html?p=nalcod>

[24] Tax Code of the Kyrgyz Republic, New Edition, <http://barwin2k.sti.gov.kg/ntaxcode/default.htm>

[25] Po bol'shomu schetu v Rossii vse naolgi nezakonny. Kommersant-Daily of 4 May, 2000

[26] Predlozheniya po dalneishemu sovershenstvovaniyu systemy vmenennogo nalogooblozheniya individual'nykh predprinimateley v Belarusi. Issledovatel'skiy Tsentri Instituta Privatizatsii i menedzhmenta, Nemetskaya ekonomicheskaya gruppa v Belarusi. <http://research.by/A3/11/04>.

[27] Problemy nalogovoy sistemy Rosii: teoriya, opyt, reforma. Chapter 7. IEPP, proceedings, #19P, Moscow, 2000.

[28] Decree of the President of Ukraine "On simplified taxation and accounting system for small business entities", # 746 of 28.06.1999

[29] Fiksirovanniy razmer naloga (putem priobreteniya patenta). Birzha newspaper of July 31, 2002, Odessa

*

NOTE FROM TRANSLATOR

Original paper is in Russian, and, since a completely correspondent notion is as yet missing in the Russian legislation and relevant lexicon, the author in the following paragraph engages in exploring various options for its wording with regard to the Russian practice. As he puts it:

“This gives rise to the problem of the lack of lexical equivalent which is best solved by borrowing of the word (“presumptive”) into Russian. On the other hand, it is hardly worth the while to “enrich” the Russian language with new words without dire need.”

In this context, a set of different choices are offered, and finally the author opts for using the wording which best integrates into the Russian discourse in economics and finance and conveys the meaning of *presumptive taxes* and *presumptive taxation*.

It is clear from the explanation provided in this comment that the choices made do not in any way affect the English translation or the discussion that unfolds throughout the paper. The paragraph is therefore omitted in the English version.

The changes resulted in deleting of part of the text and the footnotes having to do with either the deleted text or English-Russian translation of terms.