REPORT ON PRESUMPTIVE DIRECT TAXATION

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PREFACE

This report is in five chapters, and has four appendices. Chapter I defines presumption and deals with efficiency, equity, legal and information aspects. Chapter II is a review of experience in the developing world with presumptive schemes, on the basis of published information supplemented by country sources. The reason for confinement of coverage to developing countries is so as to examine relevant experience, in environments characterised by similar structural constraints and socio-economic parameters. Chapter III looks at the Indian experience with the use of presumption in all forms, particularly at the legal aspect of it. Chapter IV looks in detail at the French 'forfait' and Israeli 'tadrikh' systems, which supplement the conventional system of assessment in place in those countries. Chapter V presents detailed recommendations. Appendix I provides a lower estimate of the possible revenue gain from applying presumption to the legal profession in India, based on National Accounts Statistics which are a gross underestimate of incomes in the tertiary sector. Appendix II examines whether it might be possible to base presumptive norms on declared turnover and expenses in assessed income-tax returns, using a small sample of returns from lottery agents covering the years 1986-89. Appendices III and IV are samples of the French guidelines used for iron works, and the restaurant sector, respectively. The report concludes with a comprehensive bibliography of the literature on presumption.

An Executive Summary is provided. It summarizes the main recommendations of the authors for the quick perusal of policymakers. The authors have divided their recommendations into those immediately implementable according to their judgement, and those not immediately implementable. Among the former, they emphasize the introduction of a minimum contribution to the corporate income tax based on gross assets, with specific ameliorating provisions. This kind of tax has been successfully implemented in Latin America viz. by Argentina and Mexico in late 1980s and early 1990s, and by Peru and Ecuador more recently. Potentially a minimum tax based on gross assets at a 2% rate could typically fetch an additional 1% of GDP in tax revenue. Argentina and Mexico's revenue performance of the corporate income tax improved significantly after the introduction of this provision. Indeed, after having stabilized the revenue performance of the corporate income

tax, Argentina chose to abolish the minimum tax in mid-1994. The tax also became a major revenue earner in Mexico. While recommending this tax for the corporate sector the authors conclude that in the case of presumptive schemes for small businesses, agriculture and services, preparatory activities could begin immediately with full implementation possible in the medium term.

Although both authors assume joint responsibility for the contents of the entire report, chapters I and II and appendix I were written by Dr. Indira Rajaraman, and chapters III and IV by Mr. Kanwarjit Singh. Chapter V was jointly written. Appendix II was written by Sharmistha Roy. The remaining appendices are reproductions of country documents.

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EXECUTIVE SUMMARY

Sustainable fiscal correction will be possible in India only if ways are found by which to increase the universe of taxpayers. Programmes of tax reform elsewhere in the developing world have sought to achieve this in one of two mutually independent ways: through the use of presumption, or through schedularised final withholding at source. Both presumption and schedular final withholding may be theoretically second-best to the ideal direct tax based on self-declared income actuals with personalised deductions. But this ideal is not possible to achieve or even approach in developing countries like India, where a large volume of business is transacted in cash, and is not routed through the banking system. Faced with a consequent insufficiency of information records of the kind required for verification of self-declaration, enforcement of compliance becomes next to impossible especially in certain sectors and occupations. It is here that the need arises for base-broadening supplements to conventional direct taxation. This report looks at experiments with the use of presumption in all its forms in the developing world, as well as in France and Israel, for lessons of relevance to India. Particular attention is paid to the legal history of presumptive experiments in India, so that the measures suggested would be legally robust in the Indian context.

A summary of recommendations is presented below in two categories: schemes that can be immediately implemented; and the immediate spadework that should be begun in respect of schemes that cannot be immediately implemented. Detailed step-wise recommendations are in the concluding chapters of the Report. Suggestions are made only for presumption of taxable income from production indicators. Norms based on consumption indicators are not recommended. Consumption patterns are not sufficiently uniform or stable that one or a few non-concealable items of consumption can be related to total income in a way that is presumptive rather than capricious.

For Immediate Implementation

Some of the largest corporate giants in India today pay no income tax whatever. It is recommended here that instead of reactivating Section 115J, an asset-based minimum alternative tax (MAT), which places a floor on corporate tax payable, can effectively combat both corporate tax deferment and evasion. A presumptive rate of return of 5% on total assets, at the prevalent corporate tax rate of 40% excluding surcharge, yields a 2% levy rate on assets. A minimum alternative is crucially different from a minimum add-on in that it is not additional to the conventional corporate income tax, but carries a crediting provision against it. With that, there is an inbuilt efficiency incentive, since the incremental tax on actual income with a MAT is zero until the minimum presumed rate of return is reached.

As long as the international tax regime continues to deny tax credits in the home country for presumptive taxation in the host country, the design of a MAT should call for the conventional corporate tax to be paid in full with offset against the presumptive tax floor, rather than the other way around, **so that the MAT itself becomes payable only when the minimum tax exceeds the actual corporate income tax.** If there is in addition a provision for offset against MAT already paid in past years, or payable in future years, there is an incentive for accurate reporting of returns even where the actual return to assets exceeds the minimum presumed. The efficiency and accurate reporting incentives will lead to revenue additionality under the conventional corporate income tax, rather than under the MAT head, given the design dictated the international tax regime.

The carryback (or carryforward) provision is a critically required design feature because, by essentially converting the levy into a minimum payments provision, it serves as legal protection against the charge that the levy is unrelated to ability to pay. As a minimum payments provision, a simple structure for the tax with a minimum of qualifications and concessions can readily be justified. A levy introduced to combat zero-tax avenues in the thicket of corporate tax legislation, must itself remain simple to be effective.

Net worth as an asset-base introduces a bias in favour of debt over equity finance, and carries the problem of having to monitor fraudulent debt. The alternative of taking total assets without deduction of debt is therefore recommended instead, even though this will double-tax inter-corporate debt. This is best termed a total rather than a gross asset-base, because assets will be taken at written-down value in accordance with the provisions of the Companies Act, and will therefore be net of depreciation.

The theoretical justification for a uniform minimum asset-based levy on corporate enterprises is that free mobility of capital should in principle equate the risk adjusted rate of return to capital across all sectors. There is no equivalent justification for a minimum levy based on turnover. By the same token, a total asset-based levy cannot be extended to financial intermediaries. However, it should be extended to leasing companies, because otherwise they will constitute a readily exploitable loophole for the rest of the corporate sector.

Action on Schemes not Immediately Implementable

Presumptive schemes for the hard-to-tax sectors - small business, agriculture and services - cannot be immediately implemented. **However the process of developing occupation-specific presumptive norms can be immediately begun.** Norms for determination of taxable income from easily observable entity-specific indicators will enlarge the tax base by making possible identification of potential taxpayers from among non-filers, and by strengthening the verification and monitoring capabilities of the tax administration. Once norms have been developed for an occupation, these should be used as benchmarks in the selection of cases for scrutiny and in the process of scrutiny for all enterprises irrespective of income level. The use of norms has, however, to be backed by detailed book-keeping requirements, simplified for the lower income groups, but rigourously implemented through units distinct from those engaged in assessment work.

From the legal rulings on the short-lived section 44AC, it is clear that presumptive norms based on field surveys alone will stand the test of legal acceptability, and that all norms must be stratified by region, and occupation-specific parameters. A research group with regional units in each Chief Commissioner's Office should immediately be set up for the task of conducting these surveys, staffed not by assessment officers but by economists and statisticians.

The order in which sectors are selected for presumptive attention can be left to the discretion of Chief Commissioners, in accordance with priorities in the regional jurisdiction of each. Although norms must necessarily be region-specific, the norms developed on the basis of survey in one region can be adopted with modifications by another. Prior to field survey there should be no pre-judgement of which indicator/s, and by extension which form of presumption, whether estimation of actual income or capacity-based potential income, would be most suitable for the activity in question. The survey should collect information on all inputs, both fixed as well as variable inputs by type and quantity, as well as on the type and quantity of outputs. The appropriate indicator can only emerge after all possible indicators are examined for stability in relation to taxable income.

An activity that must be immediately begun, and carried out in parallel with the development of norms, is the task of listing practitioners of the selected occupations. A number of sources can be used ranging from registration lists with State and local authorities to voluntary membership lists of professional and trade organisations. A comprehensive listing serves two functions. It provides a frame from which to select the sample for the determination of norms. It also serves subsequently as a means by which to ensure compliance through either the presumptive or conventional routes. The difficulty with the present levy of Rs 1400 for taxpayers with turnover upto Rs 5 lakhs and income upto Rs 4700 has been the absence of any listings on the basis of which compliance could be enforced through either the conventional channel or the alternative flat levy (which is not presumptive, contrary to its label, since absolutely no presumption of any kind is involved).

Computerisation is necessary for the maintenance of occupation-specific listings. This can be worked in with the on-going project of computerisation of tax administration, in parallel with the development of norms.

Presumption does not imply arbitrary income determination. It offers a way by which the correctness of declarations can be objectively judged and the taxability of those presently outside the tax net can be objectively established. Its application increases administration efficiency and is revenue productive. It also limits the area of discretion of the administration with consequent reduction in taxpayer harassment.

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CHAPTER I

EFFICIENCY, EQUITY, LEGAL AND INFORMATION ASPECTS OF PRESUMPTION

I.1 Introduction:

The use of presumption in direct taxation is receiving increasing attention today among the large number of developing countries seeking sustainable fiscal correction as a part of macroeconomic stabilisation efforts. A recent development is that presumption is being extended beyond the hard-to-tax sectors of small business, agriculture and services which together constitute its traditional province, to cover large corporate taxpayers. This report examines experience with the use of presumption in all its forms in the developing world, as well as in France and Israel, for lessons of relevance for India. Particular attention is paid to the legal history of presumptive experiments in India, so that any recommendations made would be legally robust in the Indian context.

Presumption has already found a place in many of the programmes of tax reform initiated in the developing world in 1970s and 1980s. Although "much remains to be done to systematize and evaluate" the diversity of experience with tax reform in the developing world over this period (Bird-Casanegra, 1992: 11), key elements of consensus on reform directions can quite clearly be discerned.[1] One principal point of universal agreement is that no revenue improvement is possible if tax design fails to take into consideration the constraints faced by tax administration in developing countries in practice.[2] Pervasive non-compliance in direct taxation has made the pursuit of vertical equity through progression in a global income tax increasingly subordinate to the search for improved equity through expansion of the tax base (Khalilzadeh-Shirazi-Shah, 1991: 459 and Gillis, 1989: 18). As the Chelliah Tax Reforms Committee

concludes, "...it becomes clear that equity would be vastly improved if we could move towards less progression combined with more adequate coverage" (Chelliah Committee Interim Report, 1991: 35).[3]

Expansion of coverage in the continued presence of an information vacuum has been attempted in programmes of tax reform in one of two ways. One is schedular taxation through the greater use of final withholding at source. The other is presumptive taxation.

Taxation based upon self-declared income actuals aggregated and taxed on a global rather than schedular basis, is a replication in less developed countries of fiscal structures in countries at a different stage of fiscal evolution.[4] Developed countries have an income tax structure which is a product of evolution over the last two centuries away from presumption and away from schedular taxation,[5] and while the one does not necessarily imply the other, those earlier approaches are of greater relevance for the less developed economy of today.[6] Presumption, with or without schedularisation, offers a way by which substantive base-broadening can be achieved in developing countries, given their economic structure.

Central to the idea of presumption is the notion of potential taxability, as something capable of determination independently of self-declaration by the taxable entity, on the basis of presumptive norms. In so doing, the presumptive approach improves the technological capability of the tax administration to handle larger numbers of taxpayers without the self-defeating incremental cost of attempting to do so within the existing system. Scarce administrative resources are best deployed in the devising of presumptive norms applicable to those outside the tax net, whether because of failure to file, or under-declaration of incomes, that will survive tests of justice and fairness, rather than in the individual pursuit of each entity unbacked by guidelines.

Presumptive norms establish the link between tax liability and observable entity-specific indicators. Credible presumptive norms require that indicators be chosen specific to each sector or occupation, and that the norms themselves be established on survey or other objective

evidence. A levy that is not arrived at on some such objective basis does not earn the presumptive label.[7]

Criteria that come into play in the selection of indicator are ease of observation; difficulty of concealment, falsification, or substitution; and stability in relation to income. The same indicator may be more easily amenable to concealment and therefore less suitable for some occupations than for others.

The type of indicator selected determines the form of presumption chosen. One class of indicators consists of measures of **entity-specific flows** at either the output or input ends of the activity. This **estimation approach retains actual activity** as the basis for taxation, and departs from conventional income taxation only in that actual income is estimated independently of self-declaration.

A second class of indicators consists of **stock** measures of income-generating capacity, in terms of what is possible with average or normal effort rather than as a frontier, **without any reference whatever to actual current flows.** Such **capacity-based presumption** may use as an indicator either the aggregate asset-base of the enterprise measured in financial terms, or a physical measure of one or a few key assets indicative of scale of operation. Where the asset-base is embodied human capital as in the case of self-employed professionals, the indicator has to be some proxy measure such as type and level of formal qualification, in conjunction perhaps with years of professional experience.

A third type of presumption, where no entity-specific information of either the flow or stock varieties can be accessed, is based on an income average across enterprises. This type of **flat presumption** results in a uniform levy per enterprise. What distinguishes this from a licence or other such flat fee and qualifies it for the 'presumptive' label is that there should be an explicit underlying exercise based on survey or other evidence establishing average taxable income for the activity in question.

Thus, there are three possibilities:

a. Estimation, based on flow indicators.

b. Capacity-based presumption, based on stock indicators.

c. Flat presumption.

The terms presumption and presumptive norms will be used quite generally in this report to cover all three of the above.

It is a commonplace in the taxation literature to recommend presumption in some form for the vast informal sector of small business, agriculture and service sector enterprises. The difficulty of taxing these sectors, collectively termed the'hard-to-tax', is universal. Even in Japan, a 1984 study tested and confirmed the popular "ku-ro-yon" or "nine-six-four" perception that compliance among wage/salary earners, non-farm self-employed, and farmers was 90%, 60% and 40% respectively (Shoup, 1989: 206). In the class of developing countries, the percentages for the last two are much lower (Soos, 1991: 113-120). All components of the hard-to-tax are by no means potentially small taxpayers (Bird, 1983: 10); indeed, some evasion-prone professional groups include the highest income recipients in any country. Even so, were presumption to be confined to these conventionally sanctioned sectors, its potential revenue productivity might be regarded as limited.

What has moved presumption to centre stage in recent years is its possible use with respect to the corporate sector, in particular large corporate taxpayers. In any tax system, there is a small group of taxpayers who together make the largest revenue contribution, aggregating across different taxes as well as various methods of payment. It is now an accepted dictum that concentration of administrative attention on these large taxpayers yields the highest incremental reward to effort.

At the same time, the need for applying presumption to the hard-to-tax is not to be lightly dismissed on either revenue or other grounds, although the dearth of information is

such that making even a rough estimate of the likely revenue yield poses difficulties; an attempt is made, however, in Appendix I for the legal profession, on the basis of the notoriously underestimated National Accounts data on incomes in the services sector. Pursuit of taxes within the conventional structure for these yields a marginal revenue abysmally below the marginal costs of assessment and checking of self-declared income actuals, in the absence of the necessary information base.[8] Simultaneously with the introduction of presumptive schemes, it must be made clear at the outset that certain tertiary sector activities, most especially street services, will be completely exempt from any form of taxation.[9] The purpose of introducing presumption is to improve the equity of the tax structure, not to worsen it.

Along with presumption, developing countries have also turned increasingly to schedular taxation through final withholding at source. Presumption and schedularisation are both source-specific, but the one does not necessarily imply the other. The presumptive or estimated income from a certain source or sector can be merged with all other income of a taxable entity to yield an income taxable globally, without any sacrifice of vertical equity. Thus the use of presumptive norms by no means requires schedularisation. A schedular rate structure combined with a presumptive base,[10] with rates independent of those levied on the global income of the entities to whom the presumed income accrues, does not necessarily rule out the possibility of achieving any desired degree of progressivity in the rate structure (Tanzi, 1991: 197); it may be the only alternative when the entities lie outside the global tax net altogether. On the other hand schedularisation may be independently implemented, as for example through final withholding at source on actual incomes, with no presumptive component. Thus schedularisation does not require a presumptive tax system either.

Final withholding is a decisive departure from notions of equity enshrined in the principle of progressive taxation of globally aggregated income. The only reason tax administrations in developing countries have increasingly resorted to this[11] is because of the information vacuum in which they are forced to function. Unless there are objective bases on which to verify self-declaration, provisional withholding that can be credited against a final globally assessed tax liability merely adds to filed claims for refunds, without any revenue additionality. Thus, final

withholding reduces the need for filing, and so releases administrative manpower for deployment in more revenue-productive tasks. A new development of recent years is a provisional withholding on pre-retail transactions, which can be credited towards either direct or indirect tax (VAT) liabilities, or both.[12] This in itself calls for some flexibility in tax administration, which is often divided in developing countries into mutually independent channels for the collection of direct and indirect tax revenues.

Presumption can coexist with conventional assessment in the form of a minimum levy, or in the form of a final source-specific estimated or potential income that is either globally merged with other income, or levied at separate schedular rates. There is no particular argument for replacing the conventional income tax structure already in place, although suggestions for wholesale replacement can be found in the literature (Allais, 1977). The closest to wholesale replacement of conventional assessment by presumptive taxation was that attempted in the Bolivian tax reform of the mid-eighties, described along with other country cases in Chapter II.

Section I.2 of this chapter will examine efficiency and equity aspects of presumptive taxation, and issues that arise in the choice of presumptive indicator. Section I.3 will cover legal and information requirements of presumption.

I.2 Efficiency and Equity Considerations:

There are two approaches, somewhat orthogonal mutually, to the theoretical treatment of presumption. In the first, there is seen to be an efficiency advantage to presumption based on potential income, i.e. capacity-based or flat, over taxation of income actuals, whether estimated through presumptive norms or based on self-declaration. Essentially this derives from the fact that the potential income approach prescribes a flat absolute liability per unit capacity, or per entity in the case of flat presumption, with **a marginal tax rate with respect to incremental actual income (from the presumptive source) of zero**. This neutrality with respect to the work-leisure choice, although a well-known[13] advantage of presumption of potential income over taxation based on income actuals, is restated in subsection I.2.1.

In the second approach, it is income actuals, accurately measured and reduced by individual-specific corrections for ability to pay, that is the theoretically ideal base of taxation. Presumption is a second-best, carrying the cost of divergence from the horizontal equity ensured by the perfect income tax, but possibly yielding benefits at the margin that might make it preferable under certain values of the relevant parameters. This will be detailed in subsection I.2.2.

The third subsection I.2.3 goes into some practical considerations that arise in the choice of indicator.

I.2.1 Efficiency Advantage of Presumptive Taxation Based on Potential Income: Work/Leisure Neutrality. Formally, using the notation and model developed by Sadka-Tanzi, 1993:

If $z = yn$;

where z : actual income; y : effort index; n : normal income;

then $n = z$ for $y = 1$; and $dz/dy = n$

Thus normal income, n, is what actual income, z, is at normal effort ($y = 1$); n is also the marginal productivity of effort in terms of actual income.

The consumer maximises utility, u:

$u = u(x,y)$; where x : consumption; and y : effort index;

$du/dx > 0$; $du/dy < 0$; $d^2u/dx^2 < 0$; $d^2u/dy^2 < 0$;

subject to $x = z - T$; where T = total tax payable.

Thus, consumption, x, equals total post-tax income.

If actual income, z, is the tax base:

$T = T_A(z)$; $\Rightarrow$ $T = T_A(ny)$;

Thus, $x = ny - T_A(ny)$;

$\Rightarrow$ $dx = [n - \partial T_A/\partial y]\, dy$

Whereas, if normal income, n, is the tax base:

$T = T_N(n)$, where the presumptive taxation function T_N can incorporate any desired degree of progressivity with respect to potential income;

Thus, $x = ny - T_N(n)$

$=> \quad dx = n\,dy$

Thus, taxation of potential income does not reduce the pre-tax marginal productivity of effort. By contrast a conventional, or estimated, levy based on actual income, lowers the marginal reward of effort. A corollary of this is that the optimal tax on actual income is not necessarily progressive, whereas the optimal tax on normal income is necessarily progressive (Sadka-Tanzi, 1993: 69).

Implicit in the Sadka-Tanzi actual income function is a production function with an exogenously given endowment of capital, which is activated only by effort; $z = 0$ when $y = 0$. If K is the exogenously given endowment of capital, tangible and intangible,

$z = pq = p\,[f\,(Ky)]$, where p is price and q quantity of output. On the assumption of a constant returns to scale function, we have

$z/K = p\,[g\,(y)]$.

Thus, normal income per unit endowment of K can be determined at $y = 1$. K is the occupation-specific asset indicator. The total tax liability of an entity is determined by its scale of operation in terms of units of K.

Presumption can also be applied without occupation-specificity, on total assets aggregated in value terms. A special case of this is the minimum asset-based levy on corporations (with offset against actual income tax, and therefore not an 'add-on'),[14] based on a minimum presumptive rate of return. A presumptive levy, even as a minimum, carries an efficiency incentive, where a minimum add-on does not. Until the prescribed benchmark rate of return is attained, the incremental tax on income actuals is zero. Firms or individuals earning rates of return on assets below the minimum presumed pay an implicit tax on income actuals at a rate

higher than the prevailing corporate income tax rate,[15] which increases the greater the performance shortfall. This effect is enhanced when, as in Colombia, entities with actual incomes below the minimum face a higher probability of investigation (McLure et.al, 1990: 139). The Mexican design carries an incentive even for returns in excess of the minimum and for the accurate reporting thereof (see Chapter II).

Any minimum levy on businesses, whether presumptive or add-on, raises the marginal effective rate of tax (MERT),[16] and therefore depresses investment incentives. However a recent study of this effect, explicitly incorporating uncertainty, establishes through simulation that the MERT increases much faster with uncertainty within conventional corporate taxation than with the introduction of a minimum levy (Estache-van Wijnbergen, 1992). This is because the conventional corporate tax gives the government an equity share only of positive profits and not of losses, and the minimum tax is merely an additional put option on the equity share giving further downside cover. If the enhanced revenues from a minimum corporate levy can contribute significantly to macroeconomic stability, and hence to stability of corporate profits, there could be an overall fall in the MERT, even though the direct impact of the minimum tax increases the MERT (Estache-van Wijnbergen, 1992: 15-19).

Corporate minimum taxation can also be turnover-based. A turnover base, however, when applied at a flat rate across all sectors of industry, lacks the economic justification that an asset base has. The rate of return to capital, adjusted for differences in risk, should in principle be equated across sectors by capital flows, unless impeded by entry barriers. By contrast, it is impossible to prescribe a uniform share of taxable income in total turnover across all sectors.

I.2.2 **Presumption as a Second-Best:** If the starting premise is that the ideal measure of ability to pay is the individual's gross income reduced by individual-specific itemisable deductions, presumption becomes a second-best option which trades off the accuracy of tax-base measurement against the cost of that measurement. In an interesting recent paper, Slemrod-Yitzhaki, 1994, identify the parameters governing the optimal presumptive tax, where it is presented as an option to be exercised by the taxpayer. The particular tax which is considered

is the standard deduction, which in the US is an alternative to the claiming of itemised deductions. The optimal level of the standard deduction becomes that which equates at the margin the benefit, in terms of the saved resource cost of claiming and verifying itemised deductions, and the cost, which is the social price of the divergence from the horizontally equitable ideal on account of taxpayers opting for the standard deduction.

The model can be operationalised if the joint distribution of incomes and itemisable deductions, and the costs of collection including compliance costs borne by the taxpayer himself, are known. Although the social price placed upon divergences from ideal horizontal equity is not objectively measurable, the model can be solved for it on the assumption that the given level of presumption, the standard deduction in this case, is at the optimal level. Slemrod-Yitzhaki, 1994, do this with US income-tax data, on the assumption that there is zero evasion.

The model is clearly generalisable to other forms of presumption, but the introduction of evasion could alter the result. Specifically, as is frequently the case in developing countries, if there is regressive enforcement of the income tax among salary recipients who are at the lower end of the income scale, the introduction of presumption would actually constitute a move towards, rather than away from, vertical and horizontal equity. Another way of stating the same thing is that, for a typical developing country, the resource costs for a zero-evasion enforcement of the horizontally ideal tax are so high, that the costs of departure from that ideal through presumption are negligible by comparison at any reasonable valuation of the social price of divergence from the ideal.

1.2.3 **Choice of Indicator:** There remains the necessity of ensuring that any use of potential income must not violate notions of justice as perceived by the taxpayer. This may be more a function of equity **within** the profession than across professions. An unstratified levy with a marginal tax rate of zero might be perceived to be grossly unfair, if incomes are seen to be a function of exogenous factors unrelated to personal effort.

In the model in Section I.2.1, actual income per unit endowment, z/K, is a deterministic function of effort alone; in practice, there is a stochastic element, and a host of qualitative environmental variables, of which location is only one, which enter along with effort into the determination of actual income within a particular profession or occupation:

$z/K_i = \alpha + \Sigma \beta_j d_{ij} + f(y_i) + e_i$ for the ith taxable entity, where d_{ij} are a set of dummy variables for the qualitative environmental factors, $j = 1,...n$; and e_i is the error term.

It is only in those professions where the levy is stratified with respect to all significant environmental factors, and where the systematic component of actual income is large vis-a-vis the stochastic component, that presumption can be intra-occupationally equitable, and be perceived to be so.

In practice, since the effort variable y is difficult to observe or proxy, the empirical basis for any levy based on potential income is a simple average across all levels of effort, with intercept dummies for location and other qualitative factors influencing income.

It must be remembered that although the need for differentation has been prescribed in the context of presumption based on potential income, it applies also to presumptive norms used for the application of estimated taxation. Failure to stratify here as well, by location or other factors, could violate justice.

In the production function discussion of Section I.2.1, the presumptive indicator has been assumed to be some indicator of production capacity in terms of factor endowment. The use of consumption indicators like quality of housing for example is also possible, but not advisable. Consumption patterns are not sufficiently uniform or stable that one or a few non-concealable items of consumption can be related to total income in a way that is presumptive rather than capricious.[17]

Indicators used for estimation or presumption of potential income, must necessarily be occupation-specific, but it is possible nevertheless to list some desirable properties of quite general validity:

a. Prevention of avoidance/evasion: It is important that presumptive or estimation indicators should be so chosen as to not bias factor or input choice. In the class of estimation indicators, water usage is perhaps least substitutable, but at the same time possible to tap through unmetered channels. Evasion possibilities of this sort are fairly easy to identify, and surmountable given suitable administrative pre-conditions. The most pernicious estimation indicator to use, especially in labour-abundant developing countries, is labour usage. This immediately invites a change in labour contracts away from direct employment.[18]

It is difficult to say a priori whether estimation indicators, which require measurement of entity-specific **flows**, are more easily observable and less amenable to concealment than presumptive indicators, which as **stock** variables that calibrate the income-generating capacity of the enterprise, require observation only at discrete points in time. What is important is whether information routinely collected for other purposes, such as billing for use of electricity or water, can be easily transferred for use by the tax administration. In general, the class of asset indicators used for capacity based presumption may carry lower substitution and concealment possibilities, although here again moveable assets like livestock are more easily concealed than immoveable assets like land (Bird, 1970: 90).

b. Choosing between physical or value specification of indicator: In the class of asset indicators, valuation is unavoidable where presumption is based on total assets, but where a single asset like land is used, specification in physical terms avoids valuation problems. Schemes of the sort suggested by Allais, 1977, for expropriable self-declaration are ingenious,[19] but harder to administer than one where no valuation is involved.

c. Asset ownership or asset operation: Asset ownership as a base of presumptive taxation, places the burden of tax liability upon the owner. This would be shiftable in an asset-leasing transaction in accordance with elasticity parameters. If the price elasticity of supply of leased land is lower than that of demand, as is plausible, the levy will be largely borne by the supplier, and the equilibrium quantum leased will decline. Presumption based on asset ownership is likely therefore in the presence of the assumed elasticity configuration to be detrimental to

leasing, which in the case of agricultural land may be an objective independently desired; most reported cases of presumptive taxation especially as applied to agriculture,are based on ownership.[20] In general, however, the choice of asset operation (or occupancy in the case of housing) rather than ownership as the tax indicator will be more neutral in its impact on leasing and factor flows, and is preferable for that reason.[21] Therefore, whether an asset is owned or leased should not make a difference in its inclusion in the presumptive tax rate.

I.3 Presumption: Legal and Information Requirements:

Estimation approaches, where presumptive norms are used to generate income actuals, amount to a standardisation of the provision for 'best judgement', which exists in most conventional tax systems as an assessment prerogative over self-declaration. Thus estimation might not seem prima facie to require special legislation for its introduction. However, it has to be remembered that the threshold for the application of best judgement is a filed tax return, so that some additional legal provisions may be needed for the application even of estimated taxation to those not voluntarily filing.

The need for legal sanction for presumption based on potential income may be even greater,[22] although even here there is no departure from the principle of taxation according to ability to pay. In the words of one expert, "The essence of the presumptive method is to assume that taxable income is related in relatively fixed ways to some factor (or factors) which can be more easily verified than income itself" (Bird, 1970: 89). **The shift is not one of principle, but one of the basis of measurement.**[23]

The legality of the levy is closely linked to the rebuttability of it. It seems clear that presumptive norms will be robust in the face of legal challenge only if they remain at all times an option, with the alternative of self-declaration available to those who satisfy in full a stringent bookkeeping requirement. **The right to rebut has to be backed by satisfactory books of accounts, where what is satisfactory must be statutorily prescribed, including occupation-specific prescriptions of permissible nonaccountable expenses.** At the same time, the norms

themselves have to remain legally inviolable, without any provision for negotiated adjustment to entity-specific conditions. **If adjustment for entity-specific environmental considerations is permitted and widely used, the system approaches taxation based on income actuals,** and loses the administrative advantages of using presumptive norms. Any attempt to improve the acceptability of presumptive norms through understating levies invites entrenchment of interest in special tax treatment.

Another possible legal solution might be to differentiate presumption altogether from income taxation, and to prescribe presumptive levies in lieu of income tax. The difficulty is that unless this option is available to all occupations, it is open to serious challenge on the grounds of inter-occupational inequity.

Turning to information requirements, the first and most urgent is **an updated listing of occupation-specific enterprises and practitioners by location**. Until this critical information requirement is tackled on an emergency basis, there is no check on compliance through either accounts-based self-declaration, or the presumptive/estimated option. Most of all, without such a listing, there does not exist even a frame on the basis of which a sample to determine presumptive norms can be selected.

It is most usual to formulate presumptive norms linking indicator to taxability as a **collective average** across all entities falling in a particular occupation or activity.[24] Past assessment records carry limitations of under- and mis-reporting, so that presumptive norms are likely to be robust and defensible only if based on occupation-specific field surveys.[25]

At the next stage, each taxable entity falling in a particular category needs to be scaled in terms of the relevant indicator. Where the indicator is a stock variable measuring service capacity, there has to be an initial one-point survey, with provision for periodic updating. Where the indicator is a flow variable, like electricity or water consumption, there has to be provision for the corresponding information inflow into the tax administration on a regular, entity-specific basis. As stated earlier, stock indicators are not necessarily easier to collect information on than

flow indicators, but they do have the advantage that asset data from two points in time can be more easily checked for mutual consistency than flows.

1 Gillis, 1989, surveys tax reform in the whole of the postwar period. More recent years are reviewed in Soos, 1990; a symposium on tax policy in developing countries in the World Bank Economic Review 1991, with an overview by Khalilzadeh-Shirazi-Shah; Bagchi, 1991; Bird-Casanegra, 1992; Shome, 1992; Sadka-Tanzi, 1993; and Bagchi et. al. 1994. There are also a number of country-specific reports, although the only comprehensive tax structure study with an analysis of pre and post-reform tax burden is that for Jamaica (Bahl, 1991:749-792).

2. "The administrative dimension is central, not peripheral, to tax reform" (Bird, 1989: 326).

3. Reduced progressivity through flattened rate structures are part of the standard package delivered by IMF Technical Assistance Missions (Shome, 1993).

4. Several observers have commented on the similarity of tax systems of less developed countries to that in the metropolitan country; see McLure-Pardo, 1992: 138. That developing countries become confined thereby to the narrow tax base of organised activity has been long recognised in the literature (Hinrichs, 1966; Musgrave, 1969).

5. An example of an early presumptive tax was the 1696 Window Tax in England, levied at progressive rates on the number of windows in a structure; see Lapidoth, 1977: 57.

6. Surprisingly, some developing countries themselves moved from simpler schedular to global systems fairly recently, as for example Colombia in 1927; and more recently Venezuela, Brazil and Indonesia (Gillis, 1989: 47; 267; 285 and 33). Uruguay went back to schedular taxes in 1974-75 after a twelve-year experiment with global taxation (Ibid.: 30).

7. For example, the presumptive schemes in Francophone Africa are judged to have failed because of an insufficient basis of prior sectoral study (Baldet, 1991: 26).

8. Das-Gupta, 1994b, classifies the hard-to-tax as those with a large number of independent income-generating transactions, as contrasted with a salaried employee who has in effect a single income generating transaction.

9. Perhaps the only case where this was actually explicitly done was in the 1973 Bolivian 'unified national tax', which specifically exempted certain specified occupations.

10. The poll-tax on businesses under a turnover threshold of Rs. 5 lakhs, introduced in the Union Budget for 1992-93, which carries a flat absolute levy of Rs. 1400, is not entirely schedular; it is applicable only where other income amounts to less than Rs. 5000.

11. Chile has now introduced final withholding on wages and salaries at progressive rates ranging from 5 to 50%. In Colombia, there has been a substantial increase in final withholding along with elimination of personal exemptions and itemised deductions as a part of the tax reform of 1986 (McLure-Pardo in Bird-Casanegra, 1992: 125-127). This has happened also in the Philippines as a part of the 1981 tax reform (Das-Gupta, 1994a). The withholding system in Korea is said to have the widest coverage, although it is not clear if this is final withholding (Bagchi, 1991: 71).

12. The ASDI as enacted for example in Cote'd Ivoire, is a 5% advance provisional withholding on all pretail transactions. The withholding is creditable against VAT, income-tax or business license fees (Christophe Grandcolas: private communication).

13. Sadka-Tanzi, 1993 trace the ancestry of the idea to a 1938 book by Luigi Einaudi titled Miti e Paradossi della Giustizia Tributaria (Torino: Giulio Einaudi).

14. Any levy that is additional to income taxes involves no presumption regarding income, and is basically in the nature of a wealth or property tax with a floor.

15. They may do so even at the minimum rate of return, if tax loopholes reduce taxable return much below book profits. In that case, firms may have to earn more than the minimum rate of return in order to fully exhaust the crediting provision against the MAT.

16. The Marginal Effective Tax Rate (MERT) is the difference between the before and after-tax rate of returns on a marginal investment in present value terms.

17. Even in the Israeli tax system which uses an eclectic mix of all possible indicators to establish tax liability, the use of consumption indicators was minimised because they involved "so many conjectures as to become almost wholly unreliable as independent support for an assessment of income" (Wilkenfeld, 1973: 154).

18. In the earlier Israeli system of occupation-specific tachshivim, the tachshiv for small-scale shoe manufacturers for example, which was based initially upon the number of cobblers employed, meant that work in-house was discontinued and contracted out instead to former employees; the tax base was subsequently modified.

19. Checks are introduced by making public the declared values by type of asset and location, without reference to the individual making the declaration; with a provision that any asset on the published list could be purchased by the tax administration at 140% of the declared price, and by any member of the public at 150% of the declared price. The taxpayer has the option not to sell the asset by paying 5% of the declared value to the

tax administration, and an additional 5% in case the purchase offer is from a member of the public, to the person making the offer (Allais, 1977, as reported in Sadka-Tanzi, 1993: 67).

20. Interestingly, the Raj Committee for agricultural taxation in India recommended operated acreage as the base, whereas the revised Bagchi scheme recommended owned land (Bagchi, 1978).

21. See also Bird, 1970:95, for recommendation of operation over ownership.

22. Presumptive taxation may be regarded as the limiting case of relaxation in standards of proof required of the tax administration in its pursuit of evaded tax liability (Das-Gupta, 1994: 12).

23. See chapter III of this report for further details on Indian legal rulings on the issue.

24. There are even some systems where the total amount of tax to be collected is quantified with respect to the occupation, and then allocated by quota to individual practitioners within that occupation; see Lapidoth, 1977: 26.

25. There appears to have been in Spain a system for determination of the liability of a whole occupational group, called the estimation objectiva, with provision for further allocation among individual members of the group based on data furnished by the taxpayers (Lapidoth, 1977: 68). It is not clear whether that system survives to this day.

CHAPTER II

EXPERIENCE IN DEVELOPING COUNTRIES

Presumptive taxation is levied to combat avoidance; evasion buttressed by high information costs of verifying self-declaration; and compliance difficulty, because of the difficulty of book-keeping in certain activities, or perhaps at the lower income reaches, ignorance of procedures. These objectives will be taken in turn in the survey in this and the following two sections of experiments with presumptive taxation in developing countries.

The first section, II.1, of this chapter covers general asset-based presumption applied to the corporate sector, where the principal objective is to plug avoidance, or tax deferment. Although for the most part directed at incorporated business, some levies extend right across the business spectrum to proprietorships,[1] and in the case of the 1989 Mexican minimum asset-based tax even to individuals with loans to business enterprises. The second section, II.2, covers general asset-based presumption applied to individuals, where the objective is to plug evasion of wealth-derived income. Schemes for agriculture, and for small business and tertiary sector activities, where there is a mix of compliance difficulty and intended evasion, are covered in that order in sections II.3 and II.4 which follow.

II.1 Asset-based Presumption: Corporate Entities

Why should elimination of corporate tax avoidance be indirectly achieved through a presumptive levy, when the tax loopholes which lead to avoidance can be eliminated directly in the first place? Corporate income tax legislation all over the world, no matter how streamlined at the outset, acquires an adhesive accretion of special concessions and provisions over time because the corporate sector constitutes a focused interest group with financial backing. A

secondary interest group develops, in the form of tax planners skilled in the arts of tax minimisation within the framework of what is legally permissible. Profit-making zero-tax companies are a worldwide phenomenon.[2] An indirect attack from the flank through presumptive taxation may succeed where a direct attempt to expunge special concessions may fail, and serves also to plug evasion which is possible and does occur even at the upper end of the business spectrum. An example is transfer pricing by multinationals to take advantage of cross-country differences in corporate tax rates; it is far easier to put a floor on such practices through presumption than to attempt a direct attack through construction of arm's length prices.

Table II.1 presents a summary of asset-based presumptive levies currently in force. The only example of a final presumptive levy, substituting completely for a conventional corporate income tax, is that introduced in Bolivia with the tax reform of 1986. A final levy of the Bolivian type is not eligible for foreign tax credits under tax legislation presently in force in the major countries of origin of multinationals.[3]

The recent spate of asset-based levies in Latin America is for this reason minimum presumptive rather than final, **designed so that the conventional corporate income tax remains payable in full with a crediting provision against the minimum asset-based tax, rather than the other way around**. Where this design has not been followed, as in Venezuela and Ecuador (see notes V1 and E2 to table II.1), the problem with securing foreign tax credits remains, given the present structure of corporate tax legislation in the US and other home countries.[4]

Asset-based **minimum alternative taxes** (MAT) are quite distinct from asset-based minimum add-ons, which are not presumptive in intent and are levied in addition to conventional income taxes with no crediting provision (add-ons are not the same as property taxes).[5] From a purely revenue viewpoint, there is no reason for choosing a minimum alternative levy (MAT) over a minimum add-on. **As was seen in Section II, however, a MAT contains an efficiency incentive, where a minimum add-on does not**. With the Mexican MAT model (see below), even taxes in excess of the minimum in one year can be carried back and set off against the minimum taxes paid in excess or actuals in a past shortfall year, so that firms are urged to strive

for the minimum rate of return on average over the business cycle rather than every year. The presumption regarding the minimum rate of return is either explicitly stated, as in Colombia and Nicaragua, or where there is only a prescribed asset levy, can be obtained by dividing the rate of levy by the parallel corporate income tax rate.

Assets are the usual but not the only possible base upon which to rest presumption of corporate taxability.[6] French corporate presumption, and by extension that in Francophone Africa, is based on turnover rather than assets, with rates fixed by turnover slab.[7] However, as pointed out in section 1.2.1, turnover-based presumption carries no theoretical justification when applied across all sectors of industry, and therefore such schemes are not covered in the review that follows, which is confined to the asset-based levies listed in table II.1.

II.1.1 **Final presumption**: At 3%[8] of net worth, the Bolivian levy rate on assets is the highest among those in table II.1; there is no parallel income tax, but at the rates applied to the exempted sectors (electric utilities, mining and petroleum which continue to be taxed on income in the conventional way, at rates between 30% to 40%), the levy corresponds to a presumed return on net worth of between 7.5% and 10%, which is very high. There is however some latitude in the timing of the payment.[9]

Despite its severity, the Bolivian levy seems to have been accepted, although this acceptance may have been a function of the extreme macroeconomic chaos that prevailed at the time of its introduction. Together with other starkly simple measures introduced in the fiscal package of 1986, it was an outstanding revenue success.[10] Problems with its functioning, such as that it removed the incentive to report accurately expenses including payroll (Byrne, 1994: 537), leading to base erosion in levies such as the VAT supplementary, are not the reason for its expected conversion to a MAT, which is a result merely of the lack of an international agreement on granting foreign tax credits for income taxed presumptively.

TABLE II.1

Asset-Based Presumptive Taxation of Corporate Income in Developing Countries: 1994*

Country	Parallel income tax rate	Presumptive Tax			Presumptive rate of return (col. 5 ÷ col. 2)	Carry back**	Special features
		Coverage	Asset base[$]	Levy rate			
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
FINAL							
Bolivia (1986)	i. None ii. 30% - 40%	All except (ii) Elect.; mining; petroleum	Net worth (year end) less (a)	3% None	-	-	a. Non-commercial, non-industrial assets. b. Presumptive property taxes can be credited. c. Minimum tax on mining = 2.5% of turnover.
PROVISIONAL MINIMUM ALTERNATIVE (MAT)'							
Mexico (1988)	34% (see M1 & M2)	All except financial sector	Total assets (year-average) less (a) (see M3)	2% (see M2)	5.88% (see M1 & M2)	10 years	a. Debt owed to non-financial institutions. b. Applies to non-corporate business incl.individuals with loans to businesses (except for small business; table 4). c. Grace period: 3 years (see M3).
Argentina (1989)	30%	i. All except (ii) ii. Financial sector	Total assets (year end) Total assets (year end)	1% 0.4%	3.33% 1.33%	None None	Imposed for 9 years 1 Jan. 90; Abolished 1 Sept. 93 for primary and construction in some regions; w.e.f. 30 June 95 for all others.
Nigeria (1990)	35% (see N2)	All > 4 years old	Total assets (see N3)	0.5%	1.43%	None	
Peru (1992)	30%	All	Total assets (year end)	2%	6.67%	None	See P1

Country	Parallel income tax rate	Presumptive Tax			Presumptive rate of return (col. 5 ÷ col. 2)	Carry back**	Special features
		Coverage	Asset base$	Levy rate			
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Venezuela (1993)	20%-30%	All except (b)	Total assets (year-average) less (a)	1%	3.33% - 5%	Carry forward; 3 years (see V1)	a. Investments in shares of other companies; assets used for exempt incomes (b); see also V2 b. Public sector; charitable; price regulated products; primary sector; residential property; exports. c. Applies to non-corporate business d. Grace period: 3 years
Ecuador (1993)	25% (see E1)	All	Total assets (opening) less (a)	1%	4%	Carry forward (see E2)	a. Current liabilities.
Nicaragua (1994)	30%	All	Net worth (opening)	(see N1)	4%	None	
Colombia (1974; see C1)	30% (see C2)	All except price-controlled sectors	Net worth (opening) less (a)	(see C4)	5% (see C3)	None	a. Shares/partnerships in Colombian companies; non-productive assets. Also catastrophe exemption. b. Applies to all including non-corporate business.

Source: Price Waterhouse (1994); Byrne (1994); McLees (1991a and 1991b), supplemented with reference to country sources where possible.

General Notes:

$ Total assets include fixed assets net of depreciation.

* As at the time of writing. All features as presently in operation may not have prevailed at the date of introduction.

** The typical MAT design calls for payment of current income tax in full, with credit against current MAT. MAT thus becomes payable only if it exceeds current income tax. Where carryback exists, any unclaimed credit in excess of current MAT can be credited against MAT paid in previous years, and a refund obtained. See also V1 and E2.

\# Provisional in the sense of not constituting final settlement of income tax liability for the year. The Minimum Alternative Tax (MAT) is to be distinguished from a minimum add-on superimposed on the corporate income tax with no crediting provision. There may be requirements of advance payment in respect of both the alternative tax and the corporate income tax.

Country Notes: The references in parentheses are to country note numbers that follow:

Colombia

(C1) The provision has undergone many new changes since its introduction in 1974 as an 8% presumed minimum rate of return on assets of all taxable entities, corporate and individual.

(C2) There is a special surcharge of 25% on the corporate income tax which can be taken as a deduction on taxable income.

(C3) The rate is scheduled for further reduction to 4% in 1994, but Price-Waterhouse reports the present rate at 5%.

(C4) There is no prescribed levy rate on assets. The presumed rate of return on assets is taxed at the prevailing corporate income tax rate.

Ecuador

(E1) The oil sector is taxed at 44.4% on distributed, and 25% on undistributed profits.

(E2) The Ecuador MAT is legally a basis for estimated tax payable in advance. It is non-refundable, but can be credited against future income tax payments. In design this poses even more of a problem than the Venezuelan from the foreign tax credits viewpoint since unlike the Venezuelan, it is the estimated tax that is payable in the first instance. However, since the rate of levy is low, actual payments are likely to exceed estimated payments in most cases.

Mexico

(M1) The corporate income tax rate of 34% is reduced to 17% for primary sector activities and book publishing; 25% if these activities are "industrialised". A 2% asset-based levy on these sectors implies presumptive rates of return of 11.76% and 8% respectively.

(M2) The October 1994 tripartite pacto between business, workers and government reduced the levy rate to 1.8% along with a reduction in the corporate income tax rate whose extent is not known. The pacto may have been revised after the macroeconomic crisis of December 1994.

(M3) Taxpayers can elect to use the asset base for the second preceding year instead of the current year. This allows for a two-year lag in taxability at times of business expansion.

Nicaragua

(N1) As in the case of Colombia, there is no asset levy rate, only a presumed rate of return to which corporate income tax rates apply.

Nigeria

(N2) New companies below a turnover threshold are taxed at 20%.

(N3) Operates a four-base tax of immense complexity. The minimum tax is on businesses more than four years old, and is the highest of two levied on different asset bases (0.5% of total assets; 0.25% of paid-up capital) and two others (0.5% of gross profits; 0.25% of turnover). On turnover in excess of an absolute threshold, the rate is halved.

Peru

(P1) Until the end of 1993 there was a 2% capital tax on net worth imposed as an add-on, which however could be credited against the MAT. This complication does not now exist.

Venezuela

(V1) An exception to the typical MAT design in that excess assets tax paid can be carried forward for credit against income tax payable in excess of the MAT in future years. This design reduces foreign tax credits claimable by multinationals to the extent of the carry forward.

(V2) Also assets used to provide public utilities and mass transit. Some of these exemptions are for a fixed term after which they are taxable. Deposits of financial institutions (banks and insurance companies) are deductible only to the extent of "monetary" assets, which are defined as bolivar-denominated debt securities (equity securities are in any case exempt).

II.1.2 **Presumptive minimum: Mexico** in December 1988[11] enacted the first of what has proved to be a MAT wave in Latin America, the only prominent countries that have not joined so far being Chile and Brazil. The Mexican levy invited followers because it was an unqualified revenue success and proved to be robust in the face of legal challenge (McLees, 1991a:118).

Mexican corporate income tax collections increased spectacularly after the MAT,[12] even though the direct collection under MAT remains only 5 to 8% of the total. **It must be remembered that because of the design dictated by the need to facilitate foreign tax credits, direct revenue collections under MAT are recorded only if the minimum exceeds actual liabilities in any year, and are therefore not indicative of its total contribution towards corporate collections by way of the spur to better performance and more accurate reporting of actual incomes.** In the words of Diaz, the architect of the Mexican assets tax, the MAT is "one of the few taxes the success of which is measured by how little is collected" (Byrne, 1994: 534).

Two features contributed critically to the revenue success of the Mexican levy. One is the maintenance of the rate of asset levy[13] at its initial rate of 2% through the many amendments the law has undergone since it first took effect from 1 January 1989,[14] right through a drop in the corporate tax rate from 35% to 34% in December 1993 (which suggests some flexibility in the **presumed minimum rate of return in the neighbourhood** of 6%). In October 1994 a tripartite pacto between business, workers and government dropped the rate for the first time, to 1.8%, along with a further reduction in the corporate income tax rate, whose extent is not known; the pacto is likely to be re-examined in view of the subsequent macroeconomic crisis in Mexico.

The second reason for the buoyancy of corporate collections in Mexico is what is called a "carryback" provision for refund of past MAT payments, which provides an incentive not to underreport actual incomes even in years when actuals exceed the presumptive minimum, and paradoxically serves at the same time to mitigate the severity of the Mexican levy. Any excess of actual over minimum liability, although payable in full, can be carried back ten years for credit against past excesses of minimum over actual, i.e. past

payments of MAT, and a refund obtained.

There are clearly two requirements for the revenue success, in terms of total corporate collections, of a MAT. First, the threshold minimum rate of return on assets must be near enough to, preferably at, the average pre-levy rate of corporate return, to serve as an adequate efficiency incentive.[15] Secondly, the design or administration of the tax has to carry an incentive for accurate reporting of actual income. The importance of the Mexican carryback provision in this connection is evident in the steady increase in the carryback period after the introduction of the tax.[16] Even though this provision dilutes the severity of the Mexican levy, it has been criticised on the grounds that a refund is granted to companies in years when they need it least. It has been suggested that a provision for crediting of actuals against current and future MAT liabilities would give relief from MAT in years of poor performance when it is most needed (Byrne, 1994:538). Such a provision would preserve the incentive for accurate reporting, although perhaps less effectively for companies which expect to perform consistently at or above the presumptive threshold.[17]

The base of most of the levies in table II.1 is total assets rather than net worth.[18] In the Mexican case, it was total assets less disintermediated debt. Surprisingly, the MATs which followed the Mexican did not imitate the two features so critical to its revenue success. With the single exception of Peru, all adopted a much lower rate of return as the presumed minimum. Peru alone presumed a higher minimum rate of return of 6.67%, and on a larger tax base (total assets with no deductions), but because of a lower parallel corporate tax rate, the levy on assets remained at the Mexican 2%. In all other cases, the presumed rate of return does not exceed 5%, and is paradoxically lower even where the base is net worth. Perhaps because of the lesser severity of the tax, only two of the seven followers of Mexico have carryback or carryforward provisions, and neither has it in the form suitable for foreign tax credits.[19]

A third requirement for the effective functioning of a MAT is simplicity of design. Since the fundamental purpose of a MAT is to combat corporate tax complexities, the MAT itself must not be burdensome to administer. In this respect, the Mexican design is not the best. A total base is in general preferable to net worth. It places a floor to the bias in favour of debt finance, and the consequent incentive for earnings stripping through interest

payments, which exists in the conventional corporate income tax unless it is suitably reformed.[20] With a net worth base, the problem of having to detect fraudulent debt remains.[21] However, a total asset base results in double taxation of inter-corporate lending, and is unsuitable for the financial sector.

The Mexican solution is a total asset base, with the financial sector excluded from the ambit of the tax, and all debt included in another taxpayer's base as an asset (activo), deductible (pasivo) from the gross asset base of the borrower. Any resultant loopholes are plugged by extending the assets tax right across the business spectrum to include proprietorships, and even individuals lending to the corporate sector. Since the financial sector is not subject to the MAT, loans from financial companies are correspondingly not deductible from the taxable asset base of a company. With only debt from other domestic non-financial companies or individuals deductible, this introduces a bias in corporate preference against intermediated borrowing. Individuals on the other hand would be biased in favour of intermediated lending, since bank deposits are not taxed. The final configuration of interest rates will determine the ultimate incidence of this non-neutrality. There could however be an efficiency outcome if competition between banks in the bid to place funds leads to internal restructuring and more efficient functioning of banks.

The Argentinian MAT which followed upon the heels of the Mexican, had a far simpler, and for that reason preferable, tax base. Levied at 1% on total assets without deduction of any liabilities for the nine fiscal years commencing 1 January 1990,[22] it applied also to banks and other financial entities at a reduced rate of 0.4%. The provision for taking year-end instead of average yearly values for assets as in Mexico[23] also made assessment far simpler. The Argentinian levy like the Mexican was a success in revenue terms, and the decision to withdraw it with effect from 1995 (already in effect as of 1 September 1993 for companies in agriculture, mining and construction) is a reflection not of the failure of the MAT as of a new-found confidence in enforcement capabilities with respect to the conventional corporate income tax (Byrne, 1994: 536).

Other total asset-based MATs, in Peru and Ecuador, are even simpler than the Argentinian in design, with no concessions for the financial sector,[24] although in the fearsomely complex case of Nigeria, the total asset base is one of four operating

simultaneously and Venezuela has a large number of exemptions, which defeat the very purpose of a MAT. Some of these exemptions may be necessary, as for example for those sectors where price controls on outputs imply a corresponding profit constraint. In such cases, there has to be a lowering of the minimum presumptive rate of return, though not necessarily to zero. Only two of the eight MATs in table II.1 are based on net worth.

In general, corporate presumption whether of simple or complex design has been successful in revenue terms, and to the extent this reduces uncertainty in corporate returns via greater macroeconomic stability, could more than outweigh the disincentive effects on investment of a rise in the tax burden (see section II).

A possible alternative to asset-based presumption could be a minimum levy on book profits of the type that was in force in India (section 115J) in 1988-90. This would be akin to, although much simpler than, the 1982 U.S. corporate alternative minimum tax[25] which, although neither presumptive nor asset-based, was the inspiration for the subsequent wave of minimum presumption taxes in the developing world. The experience with Section 115J is detailed in Chapter III of this report.

II.2 Asset-based Presumption: Individuals

The case for a general asset-based presumptive levy on individuals is much less persuasive than it is for corporate entities. Most countries have in place asset-based add-ons to the individual income tax in the form of property and wealth taxes. Successful evasion of these is a function of the high cost of accessing information on assets of individuals, and mere introduction of wealth-based presumption can do nothing to change the underlying information vacuum.[26] Nevertheless, there are two experiments with general asset-based presumption for individuals, which are deserving of attention.

II.2.1 Final presumptive: **Bolivia**, as a part of the 1986 reform, removed the conventional income tax on individuals along with that on corporations, and replaced it with a final asset-based presumptive tax (Silvani-Radano in Bird-Casanegra, 1992: 26; and Gillis, 1989: 15). The elimination of the income tax was however less tidy than in the case of corporate entities, because the reform package included a "VAT supplementary" levy at a

flat 10% on income from all sources.[27] The VAT supplementary is not a conventional income tax because VAT paid by the taxpayer, also at 10% until 1 March 1992, but now at 13%, can be credited against it;[28] indeed, the motive for its introduction was to plug VAT evasion. The VAT supplementary thus reduces to a tax on consumption of goods and services supplied at the last point by dealers falling below the VAT threshold,[29] and on savings, minus what can be claimed with VAT vouchers bought on what is now an active secondary market.

Thus, the Bolivian assets-based tax on individuals remains as the only **comprehensive** tax on income via presumption. It is based on **real property** owned in three parts: **rural** property; **urban** real estate; and, interestingly, **powered vehicles** of all types including boats and aircraft. From the rates of levy, which range progressively from 1.5 to 3% for land,[30] it is impossible to infer the underlying presumption regarding rate of return without a parallel income tax rate. If the VAT supplementary rate of 10% were to be used as the only available proxy for the income tax rate, the presumptive rate of return ranges from 15% to 30%, which seem rather high. The element of presumption in respect of the powered vehicle component, for which the rates of levy range progressively from 1.5% to 5%, is entirely unclear.

The tax is collected by the central government, with varying shares in the neighbourhood of 60% earmarked for municipalities and local bodies.[31] It is reported to have been very successful in revenue terms although the rural land component is essentially inoperative in practice.[32]

II.2.2 Presumptive minimum: Colombia in 1974 enacted a minimum presumptive levy which extended to all entities subject to an income tax including individuals,[33] a measure considered to have been the most important in the major tax reform package of that year (McLure in Gillis, 1989: 61).[34] Income was presumed to be **8% of net worth, reduced to 7% in 1990**,[35] and further in stages to a **present rate of 5%**.[36] The rate reduction has been an accompaniment to better inflation indexation of the asset base. An overlapping estimated levy at 2% of gross turnover for individuals running businesses was in force from 1983 until 1990. A tax on income actuals was computed in parallel, and the highest of the three was payable.[37] The presumptive levy coexisted also with a net wealth tax until the latter was

phased out with effect from January 1992.

The revenue impact of the presumptive provision is judged to have been very successful, with increased collections by 25% at the top despite avoidable design defects[38] (McLure-Zodrow, 1990), although not because improved information on the asset holdings of individuals resulted from it; indeed, with the withdrawal of the parallel wealth tax in 1992, it is expected that the information base and enforcement capabilities with respect to the presumptive levy would weaken (Ibid: 97). The incremental contribution of the levy probably hinged fairly crucially on the provision whereby returns showing actual income below the presumed minimum were subject to investigation and audit.

Where the pre-existing information base on the asset holdings of individuals is weak, mere introduction of a presumptive minimum on wealth-derived income cannot improve it. But where the base exists because of an income tax reinforced by a wealth tax, it is possible to argue that a presumptive minimum which operates as in Colombia as an investigation threshold, would improve the enforcement of taxation of wealth-derived income (McLure et.al., 1990:139).

In any net worth levy of this type, there are problems with fraudulent debt claims, and the recently introduced provision in Colombia to allow deductions only for debt incurred to purchase assets included in net wealth is difficult to enforce. The introduction of justifiable clauses to avoid hardship, such as catastrophe exemption (especially with respect to agricultural assets), and exemption for sectors where the output is subject to price control (such as for rent-controlled urban housing), opens the door to other less justifiable exemptions (see section II.3).

Many urban property taxes on holdings of real estate are based on presumptive norms regarding the income yielded by the asset in question. Since the actual incomes from these assets are normally taxed through the individual income tax, property taxes are not normally regarded as presumptive income taxes, although they constitute the kernel of what could be expanded with updated valuation of urban properties into a presumptive income levy on urban real estate.[39]

Turkey operates a presumptive tax on individuals based on consumption indicators such as ownership of assets like houses and cars as well as foreign travel and the number of domestic servants employed. Further details such as whether it coexists with a conventional income tax, are not reported (Bagchi, 1991: 57). The French use of consumption indicators in detailed in Chapter IV.

II.3 Land-based Presumption: Agriculture

The case for the introduction of a land-based presumptive levy in agriculture, with a catastrophe-exemption provision, is widely considered to be incontrovertible. Even without intent to evade, agriculture, especially as practised in developing countries with large numbers of petty cash transactions, poses compliance problem because of the difficulties of record-keeping.

The chances of defending land-based presumption against attack by agricultural interests are higher prima facie if the levy is on land calibrated in physical rather than value units, stratified by soil quality and irrigation, with location-specific yield figures that are continually monitored and updated. This can be done in terms of as few as three to four strata by soil/irrigation type for each region and a dominant crop for each, and is decidedly not the same thing as having to rate each farm.[40] The physical properties of the soil are more immutable, or more slowly mutable, and therefore likely to be more robust in the face of legal challenge than land value, especially where, as in the case of agricultural land, instances of sale may be few and far between. The additional difficulty with market value is that it incorporates location parameters such as nearness to urban agglomerations, unrelated to potential income from use for agricultural purposes.[41] The alternative of estimating potential use value (as recommended by Bird, 1974: 237), involves the same procedure of valuing updated crop yields as that recommended here, with the possible disadvantage of loss of transparency. When yield estimates and product prices used are made explicit, the degree of updating or lack thereof are easier to assess than with a consolidated use value figure for land. Further, updated information on yields and product prices requires no incremental information beyond what is already collected from pre-existing data-collection networks in place for national income purposes, unlike updating of land values. The avoidance of land valuation in any form also sidesteps the issue of how to deal with structures or improvements

which may not be yield-enhancing.[42] Progression is possible after aggregation of holdings by ownership or operation, but less easy to administer than a flat-rate tax (Strasma in Bird-Oldman, 1990: 442).

The most enduring, and in that sense the most successful, model is the French 'forfait' system of presumptive taxation of agricultural land, which is levied on land measured in physical units at rates stratified by region and farm activity (Tanzi, 1991). Variants of the forfait on agricultural land continue to be practised in Morocco and other Francophone African countries. The Uruguayan experiment of 1967 was also like the French forfait at a rate per hectare by quality of land, but a principal reason for its failure seems to have been that soil quality classifications in terms of fractions or multiples of the national average, were based on outdated and therefore easily challenged valuation records (Tanzi, 1991).

An example of a successful valuation based system of very long standing is that in Chile, on income presumed at 9% of land value until 1954, 10% thereafter. The Chilean system is commended by Bird in his definitive survey of land-based agricultural taxation in the developing world, although even there, assessed values failed to keep up with inflation (Bird, 1974: 74). There is a provision for the indexation of property values with an index based on agricultural commodities, although this still leaves relative values unchanged, with a corresponding legal vulnerability. (Foreign-owned corporations engaging in large-scale agriculture in Chile pay taxes on income actuals).[43] In Costa Rica, there is now in place a minimum presumption at 5% of the value of immovable property used in agriculture or stock-raising (IBFD-CIAT Database, 1994), although the valuation mechanism is not known. Other valuation based systems include the presumptive tax on agriculture introduced in Colombia in 1973, at 10% on a value base excluding superstructures. The following year it was extended to all, including non-agricultural assets, at a lower rate of 8%, the experience with which has already been covered in Section IV.1. However, the power of agricultural lobbies to subvert land-based presumptive taxation of agricultural income can never be underestimated. The history of the general asset-based tax in Colombia, covered in the previous section, is replete with concessions made for agricultural property.[44]

In India, suggestions for the introduction of presumptive levies on agricultural income go back to the agricultural holdings tax suggested in the Raj Committee Report of 1972, subsequently modified by Bagchi, 1978 into a more tractable and implementable scheme. The Bagchi modifications consisted principally of estimating the 'rateable value of land', or the presumptive income from land, as an average for a region with respect to one or two principal crops grown, in two strata by presence or absence of irrigation, rather than specifically with respect to each agricultural holding on the basis of its actual cropping pattern; and the use of gross output rather than net income as the basis for the calculation of presumptive income, with a corresponding downward adjustment in rates of tax applied. Bagchi also suggested the replacement of the operational holding basis of the Raj scheme with an ownership-based scheme. Operation is, however preferable to ownership on neutrality grounds (see Section I.2.3; also Bird, 1970: 95).

Since taxation of agriculture under the Constitutional allocation of fiscal authority rests with the states, it is not implementable at national level.[45] None of the State Governments have seen fit to introduce the Raj-Bagchi schemes in any form,[46] because of possible adverse political repercussions (although income taxes are levied on agricultural plantations in all states where they exist). A system of 'land revenue' levies, at low rates unrelated to present-day agricultural productivity and prices, exists in most states.[47] With the 73rd Amendment to the Indian Constitution, which gives a constitutional status to self-government at the level of village panchayats, and the search for sources of revenue whereby the panchayats are to discharge the new functions allotted to them, **the time is opportune for a transformation of the land revenue into a presumptive levy with powers of collection and appropriation given to panchayats**. This is certainly the appropriate level of government at which to impose the levy. The Bagchi design, with provision for the valuation only of the yield from land rather than of the land itself, is most appropriate for use by panchayats, because of both its simplicity and transparency. Large-scale corporate farming can be taxed on actuals, as indeed is presently the case for agricultural plantations. The issue of the sharing of these collections belongs within the province of the State Finance Commissions, although it is clear that enforcement will be enhanced if the proceeds were to be earmarked for the development of agricultural infrastructure.

II.4 Small Business and Self-Employed Professionals

Small business and services are the other two constituents of the traditional hard-to-tax sector, where presumption has been widely tried to combat the problems of large numbers of potential assessees in an information vacuum. Presumption is required not merely to combat failure to keep the requisite books of accounts in certain occupations. Were that the case, a simpler alternative might be enforcement of book-keeping. It is required also where book-keeping is practised, or can quite easily be enforced, but where well-known occupation-specific avenues for fraud and concealment call for objective bases for verification. And of course, it is required where the book-keeping requirement itself is difficult to comply with, either because of the nature of the activity, or because of the education levels of the practitioners.

Table II.2 lists the several schemes that have been tried in the developing world. Despite the wide use of presumption in this sphere there has never been a published review or databank with even a listing of schemes in operation, let alone accurate information on design, or on administrative or revenue success.[48] Perhaps the lack of attention is because these are seen as 'unfruitful' sectors from a revenue point of view. Such scattered references as are available in the literature are seriously out of date, and current information can only be accessed from unsystematic country sources, frequently in the form of verbal communications from knowledgeable individuals. Table II.2 is merely a compendium of information collected in this manner, and does not pretend to be comprehensive.

The only experiment which is well documented is the former Israeli scheme of 'tachshivim', or standard assessment guides,[49] now replaced by **'tadrihim'** meaning manuals. The tachshivim were occupation-specific methods of estimating income actuals from an assortment of output and input indicators.[50] The system derived its credibility from the survey-based method by which presumptive norms were prescribed separately for each occupation from a mix of output and input indicators peculiar to each.[51] It derived its remarkable acceptability from prior negotiation and agreement between the relevant professional bodies and the tax administration. Essentially a codification of best judgement assessment in the absence of the requisite books, tachshivim were not legislatively backed,[52] although there did exist as in most income tax systems legal sanction for the application of

best judgement (Lapidoth, 1977: 129-145). However, after the 1975 law requiring that income taxation should be based on books of accounts, use of the tachshiv had to be suspended. Tax revenues suffered as a result, despite the introduction of designated sales machines to facilitate checking of self-declared income actuals, so that the system was brought back under the name of tadrihim with some differences. A major one is that prior negotiation with business groups is no longer permissible, so that individual negotiation with the taxpayer assumes an enhanced role.[53] There are now tadrihim for 140 occupations. These do not include physicians and other such groups considered to be qualified for maintenance of adequate bookkeeping records of their activity. Chapter IV of the report has further details on the operation of the scheme.

Elsewhere in the developing world (table II.2), the presumptive levies tried have been either estimated, or flat absolutes; asset-based levies either as a percent of asset value or at a specific rate per unit of physically specified capital equipment have been more rare.[54] The estimated levies are at a fixed rate on either turnover or total inputs, or where the base is a particular input category or set of inputs, like electricity or water usage, a fixed percentage of the corresponding estimated income. The Mexican estimated scheme is based on cash flow (replacing the earlier schemes for small taxpayers; Shome, 1994: 19).[55] There is no scheme like the Israeli, based on a multiplicity of input and output indicators.

Nothing is known of how these schemes functioned in practice, but turnover is so easily concealed (Ahmed-Stern, 1991: 277) that an exclusive turnover base does not suggest success, unless small business and services are tracked by a computerised system of the kind likely to be found only where they are covered by VAT. An ingenious scheme for verifying self-declared turnover exists in Bolivia, where the VAT extends also to services. VAT vouchers can be used by customers as credits against their liability on the 10% flat income tax; this can lead to customer pressure for VAT vouchers under certain conditions.[56] The administrative demands of such a system are heavy, but with a well-computerised system clearly affords a cross-check on the 2% tax on self-declared turnover, which applies to all sectors including services (the turnover tax is a cascading indirect levy which coexists with the VAT; it is not a presumptive income tax and is therefore not listed in table II.2). There remains the problem of detecting fraudulent VAT claims. Designated sales machines, used in Israel and now required in Mexico with the new cash-flow scheme in place are

TABLE II.2

Presumptive Schemes for Small Business and Professionals

Country	Occupation	Threshold	Type	Base/Indicator	Rate	Collection	Source
srael	140 occupations	None	Estd. (occupation-specific "tadrihim")	Mix of total turnover/ inputs by category (occupation-specific)	Statutory rate on estd. income	Income tax	Country sources 1994
olivia	i. Transport ii. Retail; artisans	None Cap < $4000	Estd. Estd.	Turnover Total input (54% of value)	Fixed % Fixed %	Income tax Income tax + VAT	Country sources 1994
hile	i. Cab drivers ii. Small traders; artisans iii. Ambulatory sellers	None Two annual tax units None	Flat pres. Flat pres. Flat pres.	No. "tax units" (indexed) No. "tax units" (indexed)	Fixed % Fixed % Indexed absolute	Income tax Income tax Income tax	Country sources 1994
osta Rica	i. Doctors; architects; engineers; lawyers; accountants; brokers; notaries; economists ii. All other technicians/ professionals	Not filing Not filing	Flat pres. Flat pres.	Abs. = 1.335 m. col. (1/2 for < 5 years experiences; indexed) Abs. = 0.89 m. col. (1/2 for < 5 years experiences; indexed)	Fixed % Fixed %	Income tax Income tax	IBFD-CIAT data-base 1994
cuador	Services	None	Asset-based pres.	Value of premises	Fixed %	Income tax	Lapidoth, 1977
uatemala	Professionals	Not filing	Flat pres.		Unindexed absolute	Income tax	Bahl-Martinez-Vazquez 1992
lexico	See country note	See country note	Estd.	Cash flow	Fixed %	Income tax	Shome, 1994
araguay	Small business	Turnover < $14000	Estd.	Inputs by category (value)	Fixed % estd. income	Income tax + VAT	Country sources 1994
ruguay	Small business	Turnover < $22000	Flat pres.		Unindexed abs = $55	Income tax + VAT	Country sources 1994

Country	Occupation	Threshold	Type	Base/Indicator	Rate	Collection	Source
Ghana	i. Taxi drivers/ fishermen	None	Asset-based pres.	Main asset (phys. units)	Unindexed abs./asset unit	Min. income tax	Lapidoth, 1977: 33-34: based on Std. Assessment Act of 1963
	ii. Goldsmiths & 20 other trades	None	Flat pres.		Unindexed absolute	Min. income tax	
	iii. Professionals by type	None	Flat pres.	3 strata by years of practice	Unindexed absolute	Min. income tax	
	iv. Racehorse owners	None	Estimated	Winnings	Fixed %	Min. income tax	
Sierra Leone Lesotho, Nigeria	Services	None	Flat pres.		Unindexed absolute	Income tax	Malik, 1979
Cameroon	Services	None	Flat pres.		Unindexed absolute (% Licence duty)	Income tax	Malik, 1979
Niger Gabon	Services	None	Estd.	Turnover	Fixed %	Income tax	Malik, 1979
Morocco	Services	None	Estd. + Flat pres.	Turnover for estd. components	Fixed % base + Unindexed abs. (% Licence duty)	Income tax	Malik, 1979

General Note: The coverage of Francophone Africa is not complete. In general, however, presumptive schemes for small taxpayers in Francophone Africa are judged to have failed becaus they were not based on prior sectoral studies (Baldet, 1991: 26).

Country Notes:

1. *Israel:* The tadrihim are the set of tadrih for each of 140 occupations where standard books of accounts are not widely maintained; an eclectic mix of output and inpu flow indicators, along in some cases with stock indicators, is used to arrive at the estimated income of each taxable entity. This is then taxed at statutory rates applicabl to all income.
2. *Bolivia:* There is no special provision for presumptive taxation of services, but since the VAT supplementary (see Section IV-2) heavily biases customers towards thos who supply VAT vouchers, there is pressure on service professionals to levy VAT. They are also liable to pay the 2% turnover tax on gross receipts, which coexist with the VAT.
3. *Chile:* The Tax Unit corresponds to a certain quantum of taxable income, indexed each year for inflation. Each category that is presumptively taxed is assumed to have a taxable income in terms of a certain number of monthly or annual tax units, which is converted to its indexed absolute equivalent at current day prices to which the lev rate is then applied.
4. *Costa Rica:* There is also a 10% final withholding tax on gross amounts paid as fees or commissions to service professionals; it is unclear how this scheme is meshe with the presumptive income scheme.
5. *Mexico:* Prior to the tax reform of 1988, there were two schemes. The Special Basis Taxpayers regime (Bases Especiales de Tributacion) applied to transport, primar and publishing enterprises, and divided enterprises into two groups; those below some threshold paid an asset-based lumpsum levy while those above paid an estimate levy based on a profit coefficient applied to actual turnover. There was also the Minor Taxpayers Regime (Contribuyentes Menores) which was for small enterprises i all other activities with a gross income below a threshold of $70,000 - $100,000. These are reported by Mukherjee, 1994b to be currently in existence, although Shome 1994 reports that the cash-flow scheme has replaced both.

prohibitively capital-intensive for a developing country.

Inputs as a base for estimation can be more reliable than turnover, if confined to key inputs like electricity whose billing system is computerised, provided norms linking electricity usage to taxable income are sector/occupation-specific. The French forfait system for example, although applicable on the basis of turnover, proceeds on the basis of data on inputs, from which turnover is determined by application of the coefficient in the relevant occupation-specific 'monography'(see Chapter IV for more details).

Flat presumption is levied in one of two ways. There is either a flat taxable income of which a fixed percentage is levied, or there is a flat levy without any explicit reference to a base or indicator. In Chile for example, the levies on cab drivers and small traders are of the first type, on ambulatory sellers at the second type. In either case, it is clear that **either the taxable base or the levy itself must be indexed.** The unindexed absolute levies of Ghana or Guatemala, for example, were recipes for failure. Even specific asset-based levies, as in Ghana per car for taxidrivers or per boat for fishermen for example, have clearly to be indexed if they are not to dwindle to revenue insignificance. One indexation variant which seems to have worked well is the Chilean system for rating the taxable income of different occupations in terms of 'tax units'; the number of tax units remains constant, although the absolute equivalent at any time is at current indexed values, on which a fixed percentage is levied. Alternatively, as in Costa Rica, the flat presumptive levy itself may be indexed.

An essential administrative requirement of a successful small enterprise levy is the need for enforcing compliance at a routine point of contact between the authorities and the enterprise, so that there is no incremental cost of contacting large numbers of taxpayers. In Mexico, this was done for some of the establishments falling under the earlier schemes for small taxpayers by issuing a stamp issued by the tax department, which in turn was necessary for (obligatory) registration with the relevant authorities. A levy based on electricity use could similarly be enforced at the point of payment of electricity bills, although of course this places a heavy burden on that part of the administrative machinery, and introduces a further incentive for power theft.

Details on the use of presumption in India can be found in the chapter that follows. But mention should be made here of the 1992 flat levy of Rs 1400 on small business (section 115K), which is widely referred to as a presumptive tax, and indeed in popular perception is synonymous with the term, erroneously as it happens, since the presumptive component in it was deleted after one year of its introduction. There was initially an explicit presumption of taxable income at 7% of turnover applicable to retail traders alone, with all retailers deemed to be at the turnover ceiling of Rs. 5 lakhs. With the widening of the occupational coverage of the scheme, its applicability was stipulated in terms of that level of taxable income at which a conventional income tax would work out to a levy of Rs 1400; the stipulated income has been steadily raised from its initial level of Rs. 35,000 to keep pace with increases in the exemption limit and is currently Rs 47,000.[57] Thus, the scheme as it presently functions has no presumptive elements in it, and is merely a simplified voluntary option for those outside the tax net falling within a taxable income ceiling, at which ceiling those opting for the scheme are deemed to be.[58] For those at lower levels of income, the higher tax liability under the scheme is offset by a simplified compliance procedure; for those above, to whom the scheme does not technically apply, there is the added inducement of a lower tax liability with a low probability of detection.[59]

At the end of the two-year period for which the scheme was initially introduced, the total number of new tax entrants numbered around 2 lakhs as compared to the expectation of 10. The principal difficulty lay not **with the small numbers opting for what was a voluntary scheme, but with the lack of any reference lists on the basis of which compliance could be enforced through either the simplified scheme or through conventional accounts-based self-declaration.** There is an inducement to comply only when not opting for the simplified scheme implies follow-up through the conventional assessment stream. The same problem afflicted the estimation scheme for construction contractors and the capacity-based presumption for truck owners introduced in 1994 (sections 44 AD and AE), also voluntary options.[60]

What is important in all these schemes is that taxes should be paid through either of the two channels, not that collections through the simplified channel should necessarily record increased receipts (and indeed there is evidence that the near doubling of receipts under the Rs. 1400 scheme in 1994-95 as compared to 1993-94 has resulted in some businesses being

forced to pay under both channels in the precincts of zealous tax officials anxious to meet revenue targets). This has reinforced the perceived regressivity of a levy which went after the small when the big so demonstrably continue to evade the tax net. This in turn has imparted a negative connotation to presumption, unwarranted because the levy is not in fact presumptive, and unfortunate because presumption actually offers a way by which to enforce compliance among the big and thus to improve the progressivity of direct taxes.

II.5 Summary:

Experience with presumptive schemes in developing countries shows that they can be used as effective and revenue-productive base-broadening accretions, if well-designed, to the structure of conventional income taxation already in place.

All evidence suggests that the most successful use of presumption has been with respect to the corporate sector, as an effective tool against avoidance and evasion. Its use with respect to the hard-to-tax sectors of agriculture, small business and services, although widely recommended, has met with less success. This is due as much to design defects as to any difficulty of principle. The pursuit of presumptive taxation for these sectors holds high revenue promise, with suitable design and adequate spadework. Whatever intra-sectoral inequity may result from the use of cross-entity norms based on averages more than compensates for the glaring inter-sectoral inequity of not attempting to tax these sectors at all.

The fundamental case for looking at alternatives to conventional assessment is that scarce administrative talent in developing countries is best deployed in the devising of presumptive norms applicable to the hard-to-tax that will survive tests of justice and fairness, rather than in the individual pursuit of each enterprise in that category.

Presumption as a basis for determination of final, as distinct from minimum or provisional liability, can survive legal challenge only if it is an option that can be freely exercised by the taxpayer. Conventional assessment on the basis of income actuals can remain as a right with the taxpayer, subject to submission of satisfactory books of accounts, where these need to be statutorily prescribed. A choice between the two streams once

exercised should not be easily reversible, so that tax-minimising alternation between the two streams does not take place. The tax authority in turn has the right to insist that every taxpayer shows evidence of having filed under one of the two streams, but can clearly exercise this right only if it is in possession of listings of taxable entities, stratified by occupation, location and other relevant parameters. This is a critical information requirement, and unless it is tackled on an emergency basis and continually updated, the point of introducing presumptive norms is defeated. As long as the application of the norms is not coercive, the norms themselves can legally remain the preserve of the tax administration. Not to have this provision is to open up the presumptive channel to endless litigation and eventual defeat.

Presumptive taxation requires an adequate information base, although the cost of this can be minimised by choice of indicator, and networking with pre-existing administrative information systems. It may also call for supportive legislation, although the incremental need will necessarily be country-specific. The paradox is that if presumptive taxation is not attempted because of these requirements, a revenue-starved government will either expand the indirect tax net, or extend systems of final withholding. Both of these can potentially violate the principle of ability to pay far more than a well-designed presumptive tax.

The lessons that can be drawn from experience with presumption in developing countries are detailed below, for each sector taken in turn:

Corporate taxation:

1. The MAT enforces a floor revenue contribution from the largest potential corporate taxpayers, who are best placed to exploit corporate loopholes. Although corporate tax avoidance can be directly attacked through elimination of loopholes, the wave of recent experimentation with asset-based minimum alternative taxes (MATs) in Latin America suggests that an indirect attack through a presumptive floor on the rate of return to assets is speedier and achieves immediate revenue success.

2. An alternative line of attack might be to reactivate the minimum tax at 30% of book profits (Section 115J), which was in force in the country for two years. This would be akin to the U.S. corporate alternative minimum tax introduced in 1982, which was neither

presumptive nor asset-based, but which was nevertheless the inspiration for the subsequent wave of corporate minimum taxes in the developing world. The advantage of asset-based presumption is that it tackles evasion, in addition to avoidance/deferment through the exploitation of loopholes.

3. A uniform asset-based levy requires only the assumption of free capital flows to carry theoretical justification as a base for presumptive taxation of business income. By contrast, a uniform turnover-based levy across sectors has little economic justification, even as a basis for a provisional minimum, and can degenerate into a cascading levy. Any stock base like assets is also easier administratively because each year's calculation is an adjustment of the previous year's, unlike self-declared turnover, which presents all the difficulties of monitoring of any current flow. However, French minimum corporate presumption, and by extension that in Francophone Africa, is practised on a turnover base, at uniform single or slab rates.

4. Although a minimum add-on superimposed on a conventional corporate tax without offset could yield even more revenue, it does not have **the efficiency incentive of a MAT, under which the incremental tax on income actuals is zero until the minimum presumed rate of return is reached.** If tax loopholes reduce the taxable income much below book profits at the presumptive rate of return, the operative minimum until which incremental tax is zero will be even higher than the prescribed minimum. The greater the performance shortfall, the greater is the excess of the implicit tax rate on income actuals over the prevailing corporate tax rate.

5. **There is a strong case for an international tax agreement that leaves the choice of income tax base to the host country, without prejudice to the interests of multinationals.** As long as the foreign tax credits problem remains, the design of a MAT should call for the conventional corporate tax to be paid in full, with offset against the presumptive tax floor rather than the other way around. With such a design, revenue collections are recorded directly under the MAT head only if the minimum asset-based tax liability exceeds that on declared actuals. The total revenue contribution of a MAT is more through enhanced collections under the corporate income tax by way of the efficiency incentive than through direct collections under MAT. In the words of Francisco Gil Diaz, architect of the pioneering Mexican MAT, it is "one of the few taxes the success of which is measured by how little is collected" directly on its account.

6. One feature of the Mexican levy responsible for its remarkably buoyant impact on total corporate collections was the rate of levy, at 2% of total assets (net of disintermediated debt), corresponding to a presumptive rate of return of nearly 6%. With one exception, rates of levy in the schemes that followed have been lower even where the base has been net worth, corresponding to presumptive rates of return in the 3-5% range.

7. The Mexican high rate of presumption is [illegible] with a carryback provision. Actual liabilities in excess of the minimum, although payable in the first instance, can be carried back and offset against past payments of minimum in excess of actuals, and a refund obtained. This reinforces the buoyancy of corporate collections, by encouraging accurate reporting of corporate incomes even in years of returns higher than the presumed minimum. The provision has not for the most part been adopted in other schemes, perhaps because the levy was lower. A combination of the Mexican 2% rate of levy, with a forward refund as suggested by Byrne, might achieve the same or perhaps a slightly reduced efficiency effect, with less harshness at times of poor performance.

8. A MAT, the fundamental purpose of which is to combat corporate tax complexity, must itself be simple to be effective. A net worth base avoids double taxation of assets at both debtor and creditor ends, and is more suitable for the financial sector. A total asset base on the other hand gets rid of the problem of having to detect fraudulent debt, and offers the advantage of putting a floor to the incentive for earnings stripping through interest payments which exists in the conventional corporate levy, unless suitably reformed. However, the Mexican design of a total asset base with financial sector exemption, and avoidance of double taxation by providing for deduction of all disintermediated debt, with a corresponding extension of the tax to cover individuals with loans to businesses to plug fraudulent-debt loopholes, is complicated and introduces a non-neutrality between intermediated and disintermediated debt. On balance, the Argentinian design of a total asset base with no deduction of liabilities, and coverage of all sectors including the financial sector (albeit at a lower rate of levy), has the virtue of simplicity.

General asset-based taxation of individuals:

9. An analogous minimum asset-based minimum tax does not work as well for individuals, because the numbers involved are larger, and there are no published balance sheets. The problems of verifying asset values are formidable, and expropriable self-declaration does not

work well in practice. Because the valuation of real assets tends to be more lagged than that of financial assets, it introduces a bias in asset portfolio choice by individuals, which is greater the higher the inflation rate. On the other hand, physical assets are less easily concealed than financial assets. The net effect is a function of the relative efficiencies of the tax administration in these two spheres.

10. The use of consumption indicators, whether in the form of assets or flow indices, is best avoided altogether, because it is difficult to find one or a few non-concealable items of consumption that can be related to total expenditure in a way that is presumptive rather than capricious. One segment of the Bolivian three-part presumptive taxation of individuals introduced in 1986 is based on ownership of vehicles. Where the element of presumption in such a tax is not made explicit, it has to be assumed that the imposition is more in the nature of a luxury tax.

Agriculture:

11. Agriculture is one of the sectors with respect to which recommendations for the use of presumption are a commonplace in the literature. The incremental information requirement over and above the data collection network already in place for national income purposes is minimal where land valuation is not attempted. Although a land-value based system has functioned effectively in Chile, with inflation indexation using a price index for agricultural commodities, a system based on land measured in physical units stratified by soil quality and irrigation, using updated product prices and region-specific yields, as in the French forfait practised extensively in Francophone Africa, is likely to be both simpler and more transparent (see Chapter IV).

Small business and self-employed professionals:

12. These sectors are often dismissed as revenue-unfruitful on the basis of schemes which have either been ill-designed or ill-administered.[61] That this is not so is borne out by the Israeli decision to bring back presumption for certain prescribed occupations, after the experience of a significant fall in revenues when the earlier system of tachshiv was revoked in favour of conventional self-declaration.

13. A critical initial requirement is a listing of all potential taxable entities in a particular occupation or line of small business.

14. The additional spadework required for the success of a presumptive/estimated taxation scheme includes scaling by the chosen indicator, and stratification by the relevant parameters. Once again this will be minimised if the indicator and the form of taxation, whether estimation or capacity-based, are chosen keeping in view the possibilities of securing entity-specific information without incremental administrative effort. The chosen indicator/s must also exhibit stability in relation to taxable income, and be difficult to conceal or substitute. In the class of flow indicators, turnover is in general more easy to conceal than inputs. Where no entity-specific information is possible on a suitable indicator, flat presumption is the only option.

15. Presumptive norms linking indicator to taxability have to be established on the basis of survey or other evidence. The acceptability of the norms will be a function of the nature and transparency of this evidence; of the choice of indicator, which has to be done on an occupation-specific basis; and of the parameters by which stratification is done in each occupation. The present-day Israeli tadrihim specifically proscribes the earlier practice of consultation with the relevant professional bodies, on the grounds that this brought in bargaining. However, collective bargaining of that sort if it will lead to better compliance and less individual bargaining, is surely an advantage.

16. A final requirement is that the procedure for compliance should preferably be linked if possible to a pre-existing point of contact between the entity and authorities, or at the point of billing if the indicator is electricity consumption, so that the usual compliance paraphernalia are eliminated. Until all this preparatory work is done, the new tax is not ready for introduction. Thus, it is difficult to agree with some fiscal commentators who dismiss presumptive taxation as a quick fix. Sustainable, robust presumptive taxation is so slow a fix, that it can only be introduced sequentially over a period of several years, for a few occupations at a time from a queue, ranked in descending order by evasion. But if a well-designed tax is introduced after adequate spadework, the payoff is additional revenue without the usual administrative costs of collection and verification.

17. The selection of priority sectors for initial presumptive attention is a sensitive matter, and has to accord with public perceptions of justice. In order to dispel all possibilities of regressivity, it is best if an explicit list of exempt strata for the selected occupations be issued, as in Bolivia. Presumptive norms are required not merely to combat failure to keep

the requisite books of accounts in certain occupations. They are required also where book-keeping is practised, or can quite easily be enforced, but where well-known occupation-specific avenues for fraud and concealment call for objective norms for verification.

18. The temptation of attempting to increase the acceptability of norms through deliberate underestimation of tax liability must be avoided at all costs.[62] Such a strategy creates vested interests in favour of "lock-in" to the alternative channel, and compulsory graduation to the regular accounts-based assessment scheme carries its own legal weaknesses.[63]

19. Presumptive levies imposed as unindexed absolutes are doomed from the start. Instead of leaving the matter to the discretion of the tax authorities, it is better to have the indexation formula legally prescribed as a part of the norm. The Chilean system of tax units is one good way by which to achieve indexation.

20. The coexistence of sectors of the economy where conventional assessment or estimation based on income actuals are the basis of taxation, and sectors with presumption based on other than income actuals, can introduce new evasion possibilities through transfer pricing. These have to be anticipated where possible, and dealt with as they arise. None of these can be an argument for not attempting what could achieve, most especially for a fiscally constrained developing country, the twin objectives of higher revenues and better horizontal equity.

What matters for the acceptability of a tax system is the public's perception of its fairness (Chelliah Committee Interim Report:4). It is by no means the case that a well-designed presumptive levy along the lines suggested above by the experience of developing countries would violate public perceptions of justice any more than taxation based on income actuals enforced regressively.

1. Other than those falling under the special schemes for minor and special basis taxpayers (see section II.4).

2. Including in India today, despite the removal of the investment allowance, principally because of the depreciation provisions under the Income Tax Act.

3. The rulings of the Internal Revenue Service of the US, for example, disqualify foreign taxes imposed solely on imputed income (McLees, 1991b: 1173).

4. Because the Venezuelan carry forward provision reduces income tax liability in excess of the minimum, it correspondingly reduces the foreign tax credit that can be claimed (Byrne, 1994: 537).

5. In 1994 minimum add-ons, as distinct from property taxes, were in force in Cameroon (at decreasing slab rates of 1.5% to 0.5% on total assets); Ecuador (0.15% of net worth); El Salvador (0.9% to 2% of net worth); and Uruguay (2% of total assets with some liabilities deductible, 2.8% on net worth of banks).

6. Colombia provides perhaps the only instance where an asset-based presumptive tax at 8% covering all taxable entities coexisted during the period 1983-90 with a turnover-based tax at 2% on all business income and with an income tax on actuals, with the highest of the three payable. See section IV.2.

7. Turnover-based minimum corporate levies apply in Cameroon (at concessional rates upto the fifth year of activity; 1.1% thereafter, subject to an absolute floor); Congo (1%); Gabon (1.1% subject to an absolute floor); Malawi (at slabbed rates with an exemption for export turnover); and Pakistan (0.5%, not applicable to local branches of foreign companies). In some countries a requirement of quarterly payments of corporate tax as a percentage of turnover may function, in effect, as a turnover-based minimum tax if, as in Guatemala for example, refunds can be claimed only if the firm submits to an audit of its return (Bahl et.al., 1994:98).

8. From 31 March 1990 (Price-Waterhouse country booklet on Bolivia, which reports the situation as of 31 October 1992). It is reported to have started as a 1% tax (Silvani in Bird Casanegra, 1992: 49); 2% according to other sources (Bird, 1992: 13, and Byrne, 1994: 537).

9. There is a discount of 10% if the tax is fully paid on the due date; alternatively, a 30% down payment is possible, with subsequent payment by instalment, where the amounts due are indexed in line with the devaluation of the boliviano against the US dollar.

10. There is no information on the revenue contribution of the corporate levy alone, but tax revenues as a percentage of GDP rose from 1.12% prior to the reform to 7.40% by 1990. This is widely considered to have been a major contributor towards control of the Bolivian hyperinflation (Silvani Radano in Bird-Casanegra, 1992: 57).

11. Amended several times since (see McLees, 1991a).

12. Enactment of the MAT led to a 12.9% real increase in total corporate collections in 1989, the year of its introduction, at a time when parallel reforms in the corporate income tax would have led to a 1% drop (Gil Diaz, 1994).

13. Total assets less disintermediated debt.

14. First called the Business Assets Tax Law, it was amended in December 1989, effective 1 January 1990, and rechristened the Assets Tax Law (ATL). The ATL was further amended in December 1990, effective 1 January 1991.

15. Not enough time has passed since the introduction of the Mexican MAT for an assessment of whether the average rate of corporate return on assets has actually

improved, or of whether the dispersion around the mean has reduced.

16. The period is 10 years starting 1 October 1993; prior to that the period of carryback was five years, and prior to that, three.

17. It must also be remembered that other taxes on corporate entities would jointly determine the incentive for misreporting of any item of expenditure or receipt.

18. The term "total assets" is defined here and in table 1 to include fixed assets net of depreciation. The term "gross asset-based" is often used in the literature for the Mexican and other levies in the sense of their not being based on net worth (see for example Sadka-Tanzi, 1993: 71). It wrongly suggests that fixed assets were included at their undepreciated value.

19. IRS ruling 91-45 specifically rules that the Mexican carryback refund will not disqualify foreign tax credit claims.

20. Even if the information base is good and such interest does not escape taxation at the recipient end, there is still an incentive for earnings stripping through interest payments unless dividends are not double taxed, and the rates of corporate and income taxation are at par. In Mexico, the flat corporate rate of 35% and the top rate on individual incomes were brought to par in 1990, and double taxation of dividends has been eliminated.

21. Byrne suggests that another advantage of a gross base is that it enables a lower rate (Byrne, 1994: 538), although as is clear from table II.1 it does not in practice always so result.

22. The quote and other information are from Price-Waterhouse, 1994, but other sources suggest the levy was introduced for only three years at the outset (Bird, 1994: 21).

23. Mexico also has a provision under which the enterprise can elect to use its assets for the second preceding year instead of current assets, so as to give business expansion the same two-year holiday as is granted to new businesses (McLees, 1991: 118).

24. Except for a tax overlay in Peru; see note P1, table II.1.

25. The US AMT is based on an alternative computation, but on the same reported income actuals. Beginning in 1990, the book income component has been replaced with an "adjusted current earnings" concept of immense complexity, so that the alternative computation is not a simple matter.

26. It is interesting that although the US enacted an AMT on individuals in 1983, akin to that on corporations introduced in 1982, there has been no mimicry of this in developing countries unlike the case of corporate taxation.

27. Employees are entitled to an exemption of twice the national wage.

28. VAT vouchers were transferable, and an active secondary market did develop as intended.

29. The Bolivian VAT is unusual in that it coexists in the tax reform package with a conventional cascading turnover tax, that has a coverage much wider (gross income from commerce, industry, liberal professions, trades, services, interest and gifts) than that of the VAT which covers only primary products, services and imports. The rate of the turnover tax has surprisingly been increased post-reform from 1% to 2%.

30. The lower end of the range may well be lower, at 0.35%.

31. Country sources: private communication. However, a published source says that authority for collection of the presumptive tax rests with municipal governments, and that there is no single national register of taxpayers (Silvani-Radano in Bird-Casanegra: 33-34).

32. Country sources: private communication.

33. The tax applied to individuals right from the start, but during its long history, there might have been periods when it did not extend to limited liability companies (McLure et.al., 1990: 139).

34. It is incorrectly reported to have been eliminated by Law 6 of 1992 in the IBFD-CIAT Database, 1994.

35. The rate of levy may not have remained constant at 8% during the entire period until the reform of 1988. There is a decree number 3746 of 1982, raising the rate to 8% in 1985 in stages from 6% in 1982, which suggests a prior reduction from the initial rate of 8%.

36. Starting in 1994, from a reduction in 1992 to 6%, and in 1993 to 5%. It was scheduled for further reduction in 1994 to 4%, but Price Waterhouse reports the 1994 rate as 5%.

37. Further, any increase in net wealth that could not be explained due to exemptions or taxed income, was taxable as current income.

38. Such as that the minimum until the reform of 1988 was compared to total declared income, rather than to asset-derived income alone; this meant that if salary income exceeded the presumed minimum, asset-derived income could go undeclared, and tax payable only on salary income (McLure, 1990: 290). Published sources indicate this was still in force until 1988 (McLure, et.al, 1990:24), but country sources indicate it was removed in 1986.

39. If confined to commercial urban properties, there is no problem of having to exempt self-occupied housing.

40. Bird is quite right in arguing against personalised ratings of the kind called for by Wald, but this is necessary only if it is wished to bring in location vis-a-vis the market as a factor in stratification. If the location factor is to be brought in, the most efficient way is indeed to go by approximations to the market value of land (see Bird, 1974: 294).

41. There are, however, opposing viewpoints on this. Richard Bird, one of the earliest proponents of the need for incorporating presumption in the tax structure of developing countries, recommends instead a land-value based system for agriculture, which would automatically incorporate location and land quality (Bird,1970: 93). He also recommends self-assessment at expropriable rates, for further administrative simplification. In a later work (Bird, 1974: 237-240), he leans towards potential use value where the objective is taxation of agricultural income, but "with a close check being kept on divergences from sale values", and with taxation of any excess of market over use value deferred, but not exempted, until the land is sold.

42. Where valuation is recommended, opinion leans towards omitting structures from the taxable base: "...an agricultural land tax may be both simpler and slightly more desirable economically if its base does not include visible improvements" (Bird, 1974: 242). The difficult issue of operationalising this omission remains.

43. Milka Casanegra: private communication.

44. There was a 1979 exemption of 50% of the value of beef and dairy cattle (McLure in Gillis, 1989: 64), a 1983 reduction of the value of rural real estate to 75% of its cadastral value, and the further reduction to 60% of cadastral value for all real estate in 1986; all these were eliminated in the 1988 reform.

45. When the income tax was first introduced in British India, agricultural incomes were not exempt. The income tax was then withdrawn, and when reimposed permanently in 1886 did exempt agriculture (Ahmed-Stern, 1991: 16). It should be mentioned that from 1.4.1970 until 1.4.1981, agricultural properties were subject to the wealth tax levied by the Central Government, although this was in practice paid only by the small number of taxpayers that paid income/wealth taxes on non-agricultural income or property. Land is reported to have been valued at ten times the Product Index Unit, a rough measure of normal production per acre by quality (Ahmed- Stern, 1991: 254), but if true this would have been merely a convention without any legislative backing.

46. This is despite the recommendations of State-level tax reform committees. See for example the Report of the U.P. Taxation Enquiry Committee Report, 1980: Chapter II.

47. Land revenue contributed as much as half of all tax collections at the turn of the century, but its share had come down to 7% at the time of independence (Ahmed-Stern, 1991: 15, quoting other sources).

48. Databases can be not merely incomplete but also misleading. Thus, the IBFD-CIAT databank declares that in Colombia, the presumption of income based on a taxpayer's net worth had been eliminated. However, country sources affirm that the presumptive scheme continues to exist.

49. A similar scheme is reported to be in use in Korea (Ahmed-Stern, 1991: 278), but no details are available.

50. There is a three-stage determination of gross turnover, gross profit and net profit, using physical flow indicators of output, such as driving licenses issued in the case of driving schools; and of key inputs like water or electricity.

51. If not survey-based, the basis was the accounts of firms that do maintain books, or negotiation with the relevant professional bodies (Lapidoth, 1977:132).

52. Thus for example, there was a Supreme Court ruling in favour of a diamond dealer who had not maintained the requisite books of accounts, but challenged the tahshiv applicable to him on the grounds that there was no provision for deduction of a bad debt, even though the tahshiv had been agreed upon between the tax authorities and the Diamond Dealers Association (Lapidoth, 1977).

53. Shlomo Yitzhaki: private communication.

54. As for example in the earlier Mexican scheme for small transport undertakings; see footnote 5, table II.2. This also led to transfer pricing malpractices, whereby large corporate enterprises padded their haulage payments to trucking subsidiaries, whose tax payments would depend only on the number of trucks operated (Diaz in Newbery-Stern: 342).

55. Replacing two earlier schemes for small undertakings; see note 5 to table II.2.

56. If VAT vouchers were non-transferable, there would be demand for them only among those above the income tax threshold (and for those among them who save). But because VAT vouchers are transferable, this generates pressure for vouchers among all.

57. Raised in steps to Rs. 37000, Rs. 42000, and as of 1995 to Rs. 47000. The turnover ceiling remained unchanged at Rs. 5 lakhs until it was raised in the Finance Bill of 1995 to 6, although turnover no longer plays a role in the determination of taxable income.

58. Income from financial assets or sources (such as manufacturing) not covered by Section 115K, upto Rs. 5000, are taxed at 20%; recipients of higher incomes from such sources are not eligible for the scheme.

59. There is however a provision under Section 115N to investigate cases where there is prima facie evidence of higher taxable income than the stipulated level to which Section 115K applies.

60. The estimated levy on civil contractors applicable under a turnover ceiling of Rs. 40 lakhs, assumes that net profits constitute 8% of gross receipts; the capacity-based presumption with respect to truck owners specifies a specific net income yield per truck, upto a maximum of 10 trucks. Both are intended for merger with other sources of income, and taxation at normal rates on the global total.

61. The direct revenue contribution of presumptive taxation to revenue is described as weak from the evidence of experience in developing countries (unsupported by figures, but plausible nevertheless; see Bulutoglu, 1994: 6).

62. This was the case even in Israel, creating vested interest in the continuance of the system; see Lapidoth, 1977: 134 and 145.

63. Bird, 1970:96 speaks of the general acceptance of the graduation principle.

CHAPTER III

THE INDIAN EXPERIENCE OF PRESUMPTIVE AND ESTIMATED TAXATION

III.1 Overview:

Every real world income tax system has to tackle income earners who either do not maintain accounts or whose accounts are highly unreliable. It has to, therefore, contain provisions which enable actual income being approximated otherwise than through reliable accounts. The Indian income tax system is no exception. It contains provisions relating to non-residents deriving income from shipping (Section 44B), supplying machinery used in prospecting or extraction or production of mineral oil (Section 44BB), or operating an aircraft (Section 44BBA); foreign companies deriving income from civil construction (Section 44BBB) and Indian residents deriving income from construction or supply of labour (Section 44AD), goods carrier (Section 44AE) and those who have small businesses (Section 115K - 115N), which provide for income estimation otherwise than on the basis of properly maintained accounts. Section 44AC which was in force from 1.4.1989 to 31.3.1993 provided for similar income estimation in cases of liquor contractors, timber and other forest produce traders. In addition to these specific provisions the Indian Income Tax Act has also elements of presumption or estimation in regard to computation of income under various heads.

In India small retailers including those offering services like barbers, carpenters, etc., typically do not maintain any accounts. Then, there are those engaged in businesses like transporters, contractors, etc., where maintenance of books reflecting the actual state of affairs is rate, possibly in view of the nature of expenses which have to be incurred. Even in large retail outlets, requiring the maintainance of proper sale vouchers with names and addresses of the buyers is often ineffective. There is ample scope for manipulation of accounts. Those engaged in liquor sale generally obtain contracts in the names of fictitious persons or persons with no means. After the contract period is over nobody is available for cross checks or follow up action. Often, advocates, doctors, and other professionals, though

well qualified, do not maintain proper books of accounts. Large amounts of cash transactions make the task of determining their actual income difficult if not impossible. These groups are the centre of concern for the Indian tax administration in its efforts to make the income tax more broad. An alternative to address the problem is through a presumptive or estimated income tax.

This is not to say that the other groups who maintain audited accounts are all reflecting their true incomes. There are many opportunities to under-state income particularly through inventory valuation, depreciation provisions and use of heads like repairs, entertainment, and travel expenses, which are open to abuse. However, these taxpayers have generally been left out from the scope of presumptive or estimated tax approach.

III.2 Recommendations of TRC:

The Tax Reforms Committee (TRC) chaired by Dr. Raja J. Chelliah in its interim report submitted in December 1991 recommended a presumptive tax scheme for traders and manufacturers deriving income from business with turnover between Rs. 3 lakh and Rs. 5 lakh, estimated income tax scheme for the next higher group with turnover upto Rs. 25 lakh and normal income taxation for the higher income earners following the step-wise approach recommended by the Musgrave Mission on Tax Reform in Bolivia. The presumptive tax scheme as recommended by the TRC (Para 12.27) was optional and required a lumpsum payment of Rs. 1,000 without filing any return. Those falling in this category but having additional income from other sources like brokerage, commission, interest, dividend, property, etc., were to be covered provided the brokerage income did not exceed Rs. 25,000 and the receipts from other sources excluding brokerage did not exceed Rs. 10,000. The additional income, from other sources, was to be taxed @ 20%. No deduction was to be allowed on account of savings incentives or any other provision of the Income Tax Act and the payment of lumpsum tax was required to be made at one time before 15th March of the accounting year. The Estimated Income Scheme (EIS) recommended income being estimated @ 8% of the turnover from trading and manufacturing operations; 50% of the receipts from brokerage or commission; 10% of the receipts from contracts including transportation and 80% of the receipts from other sources in the nature of interest, dividends, rents, export

incentive schemes or any other receipt of similar nature. Specific recommendation was made for taxing income from contracts on above lines in para 12.28. A scheme for taxing truck owners on the basis of presumed income per truck per month was also suggested in para 12.29. Where salary income was also earned, EIS did not apply any longer. Income as computed under EIS was to be aggregated with the income from profession and income under the heads like salaries and property to determine the gross total income. In this case deductions for savings, etc., under the Income Tax Act were to be allowed. The payment of tax was to be made in advance in accordance with the provisions of the Income Tax Act. Again, no return was to be filed. The taxpayers were to file a statement along with the payment of tax in the bank.

The Committee also discussed the development of law in the case of Section 44AC and came to the conclusion that presumptive assessment may not be sustainable in law unless a chance of rebuttal is allowed to the taxpayer. It may, however, be expected that if the norms or ratios are fixed at reasonable levels most taxpayers with relatively small scale of business activity will welcome and opt for the presumptive tax scheme. The Report also took note of the tendency to suppress the sales figures. The need to devise a way of checking reliability of the reported turnover without casting too heavy a burden on the taxpayers or the department was emphasised. The Committee was of the view that a system of operating such checks can be evolved once the traders/producers start filing their statements showing the value of their fixed assets, power consumption, number of employees, size of premises and rent paid, etc. Based on these statements and work of Special Cells to be set up for this purpose the average relationship between these variables and the scale of business turnover can be worked out by using statistical tools. In the first three years, however, acceptance of the reported turnover was recommended unless there was strong evidence to the contrary. The need for studies for estimating income on the basis of physical indices in businesses like running of buses, trucks, taxi cars, marriage halls, larger saloons, beauty parlours, dyers and cleaners was emphasised by the TRC. It was of the opinion that a beginning may be made by prescribing that each truck with an inter-state permit could be presumed to yield an income of Rs. 4,000 per month while a truck with a state permit could be presumed to yield an income of Rs. 3,000 per month.

The provisions relating to small businesses, contractors and goods carriers are the result of these recommendations of the Committee. There are, however, differences between the scheme for small income earners as actually implemented and as recommended by the Committee. Also, the proposal regarding estimated income approach for those with turnover upto Rs. 25 lakh remains unimplemented except for contractors.

III.3 Presumptive/Estimated Income Taxation under the Indian Income Tax Act:

Coming to the provisions under the Income Tax Act 1961, Section 44B relating to profits and gains from shipping business of a non-resident was introduced w.e.f. 1.4.1976. Under this Section taxable profit is taken at 7.5% of the receipts on account of passengers and goods shipped to any port in India plus any amount received or deemed to be received in India for carriage of passengers or goods, etc., shipped at any port outside India. Earlier, the taxable profits were determined by apportioning the global profit of the non-resident between Indian business and foreign businesses on the basis of 'voyage accounts'. Simultaneously, Section 172 provided for ad-hoc assessment being made by taking the taxable profit at one-sixth of the above amounts. The ship was allowed to leave the Indian ports only after payment of tax on the basis of ad-hoc assessment unless there was an agent in India from whom it could be recovered. The taxpayer retained the option to file a return subsequently and ask for a regular assessment. With the amendment from 1.4.1976 in Section 44B, Section 172 was also changed with taxable profit being taken at 7.5% of the stated amounts. Section 44BB contains similar provisions for computing profits and gains of non-residents engaged in the business of supplying plant and machinery on hire for use in prospecting, extracting or producing mineral oils. This Section was introduced w.e.f. 1.4.1983 and provides for taxable profits being taken at 10% of the amounts paid for use of such plant and machinery in India plus the amounts received or deemed to be received in India for plant and machinery used for such purposes outside India. Section 44BBA introduced w.e.f. 1.4.1988 applies to income of non-residents from operating aircraft carrier and provides that the taxable profit will be taken at 10% of the amounts as indicated in the case of ships under Section 44B. Section 44BBB introduced w.e.f. 1.4.1990 provides for taxation of profits of foreign companies from construction of power projects @ 10% of the total receipts relating to such construction. Section 44D provides for determination of taxable

profits of foreign companies by way of royalties and technical service fees without permitting any deductions whatsoever in respect of agreements made on or after 1.7.1976.

The provisions relating to non-residents and foreign companies are the result of the difficulty in taxing businesses with activities in different parts of the world on account of impossibility of precise country-wise allocation of common expenses. The estimated form of taxation in this area is widely practiced all over the world and like in India has not resulted in any challenge to its legality.

For Indian residents Finance Act 1992 introduced a new scheme providing for a lumpsum income-tax payment of Rs. 1,400 by 'new taxpayers' with a turnover not exceeding Rs. 5 lakh and profit not exceeding Rs. 35,000. The scheme was applicable to retail traders, those carrying on vocations like tailoring, hair cutting, etc., or those deriving income from business of running an eating place, hiring and running of goods carriers, motor cab, etc. Finance Act 1994 has excluded business of goods carriers in view of the new provision of Section 44AE. Also profit limit stands increasing to Rs. 42,000 to adjust for the increase in exemption limit. No return is required to be filed. A statement containing declaration regarding the level of turnover and profit is required to be filed, along with the payment of Rs. 1,400 in designated banks. This scheme was introduced for a period of two years, but the Finance Act 1994 has extended it indefinitely. Those earning income upto Rs. 5,000 from sources other than those covered by the provisions of 115K are also eligible for the benefits of the scheme with tax @ 20% being levied on such additional income.

Finance Act 1994 introduced Section 44AD providing for taxation of profit from civil construction @ 8% of gross receipts where the receipts do not exceed Rs. 40 lakh. Another Section 44AE was introduced providing for estimation of income from goods carriers @ Rs. 2,000 per month per vehicle for heavy goods vehicles and Rs. 1,800 per month per vehicle for others. No deduction for depreciation is permitted. The provision is applicable to those owning not more than ten goods carriers. The assessees have a right of rebuttal, with supporting evidence, under both the Sections 44AD and 44AE. Also the declared income, if higher, is taxed instead of the estimated or presumed income as above. The income as estimated under Section 44AD is to be aggregated with other income and taxed in accordance

with the rates for the relevant financial year since taxation is not schedular.

Thus, Income Tax Act in India provides for taxation of non-residents and foreign companies on their incomes from specified sources by making a presumption regarding expenses as a percentage of turnover which is easily determined. It has provision for small income earners with upper limit of turnover and profit, restricted to new taxpayers, levying a fixed lumpsum tax and dispensing with requirement to file return but with no right of rebuttal. It has also a provision for estimated income taxation of contract income with turnover ceiling and right of rebuttal and a provision for presumptive income taxation of income from goods carriers with upper limit on the number of vehicles and again a right of rebuttal.

III.4 Evaluation of the Indian Experience:

The provisions relating to contractors and goods carriers are too recent to be evaluated. However, the provisions of Section 115K to 115N have been in operation for more than two years. An evaluation of these provisions and the response they evoked would give some insight into the problems which arise in the implementation of a presumptive scheme relating to small income earners.

The presumptive scheme for small income earners introduced by the Finance Act 1992 was restricted in its scope in comparison to the scheme recommended by TRC as it applied only to new taxpayers; manufacturers were excluded; the limit for other income was kept at Rs. 5,000 and it was introduced for a period of only two years. Even then it eased the demand on such taxpayers in as much as regular books of accounts were not required to be maintained, no return was required to be filed and contact with the tax officials was totally avoided. Administrative instructions were also issued to the effect that such taxpayers would not be subjected to surveys under Section 133A and wide publicity was given to this. Yet, the scheme failed to evoke the expected response. In the year 1992-93 1.16 lakh taxpayers filed statements under the scheme and paid a total of Rs. 16.46 crores as against the estimated potential of about 10 lakh cases and corresponding revenue of Rs 140 crores.

The questions most often raised on behalf of these taxpayers related to the likely scrutiny once the period of two years was over. Assurances were sought regarding the level of capital and savings out of the declared income of Rs. 35,000, which would be accepted by the Income Tax Administration. Many also objected to a lumpsum tax of Rs. 1,400 being demanded when those earning less than Rs. 35,000 could file a regular return and pay less tax. Paradoxically, the reluctance to take the benefit of this scheme arose from two contradictory reasons. On the one hand, the potential beneficiaries expressed apprehension that they will be taken on the registers of the Income Tax Administration and the level of capital invested or savings shown would be questioned after the period of two years was over. On the other hand, under the guidance of accountants and legal advisors, many were inclined to file returns showing income just above the exemption limit thus incurring a total cost of, say, Rs. 500 almost equally divided between the income tax paid and the fees of the accountant or the legal advisor. Implicit in this approach was the perception that the tax administration is not strong enough to detect absence of proper books of account or under statement of their incomes through surveys or scrutiny. The tax administration also failed to create a sufficiently deterrent environment by making unduly selective surveys and searches in areas where such taxpayers are located. Basically, such taxpayers were not convinced of the sincerity of the tax administration. They were, and remain, strongly under the influence of the local leaders of trade organisations, accountants and legal advisors. While the leaders of trade organisations were themselves not in a position to take benefit of the scheme being generally better off, the accountants and legal advisors, with some honourable exceptions, did not see any benefit for themselves if income earners opted for the scheme. Thus, the target group was generally not encouraged by those whose guidance it sought. Added to this was the perception that income is the surplus or savings after meeting all expenses - business as well as personal. This being typically small, the attention being paid to collect tax from them was not appreciated. There was no perceived linkage between payment of income tax and any readily identifiable benefit available to them. On the other hand, discussions indicating that income taxpayers may be denied the benefit of subsidised ration through the public distribution scheme acted as a deterrent. In 1993-94 also the response though better than 1992-93, remained subdued with 1.96 lakhs taxpayers taking the benefit of the scheme and paying a total of Rs. 27.53 crores as income tax.

Though, the experience of the presumptive tax scheme has not been upto the expectations its merit from the point of view of taxpayers and the tax administration cannot be disputed. By removing the need for maintenance of books of accounts, and shutting of any contact with the tax administration the taxpayer was at one stroke relieved of the laborious and time-consuming accounting requirement and escaped possible harassment at the hands of the tax officials or manipulating by the legal and professions. For the tax administration the scheme provided an opportunity to collect some revenue from a group which is hard-to-tax without any significant manpower deployment. The assurances regarding level of capital or the savings acceptable to the income tax department were sought mainly by the office bearers of the trade organisations, accountants and legal advisors who were themselves not covered under the scheme. With extremely limited capacity for investment or savings out of income the question of such taxpayers showing built-up capital to an extent which could be seriously questioned by the tax administration just does not arise. On the contrary any assurances given in this regard could be misused by those wanting to read into the scheme a possible tax avoidance mechanism by creating new entities. Though a number of meetings were held by the tax officials to explain the provisions of this scheme, the number of persons belonging to the target group who actually attended such meetings was limited. The real difficulty, therefore, was in reaching out to such taxpayers directly to clarify the benefits available to them through the mechanism of this scheme. With almost no interaction between the tax administration and such taxpayers in the past it was not possible to immediately establish credibility to convince such taxpayers that there were no 'traps' under this scheme.

The process would require more exposure over a period of time. It will, therefore, not be correct to treat the scheme as a failure on the basis of the experience of two years. A more appropriate approach would be to treat the scheme as a long term measure for improving the compliance levels of such taxpayers. This appears to have been the thinking while making the provisions permanent in the Finance Act 1994. However what needs to be considered is whether economic or administrative considerations justify making the scheme restrictive. Enlarging the scope of the scheme to all economic activities, except those specifically covered by other provisions, and also to all assessees, old or new, would bring it closer to the conceptual framework outlined by Musgrave and recommended by the TRC.

No discussion of the Indian experience in this area will be complete without discussing the provisions of Section 44AC which stand deleted w.e.f. 1.4.1993. This experience is discussed in detail as it provides an insight into the legal and administrative issues of crucial relevance to any steps in the direction of imposing a presumptive or estimated tax on a particular economic activity.

Section 44AC introduced by the Finance Act 1988 w.e.f. 1.4.1989 applied to liquor contractors, timber traders and traders in other forest produce other than a public sector undertaking. It provided for income estimation at a fixed percentage of the 'purchase price'. This being 40% for liquor, 35% for timber obtained under a forest lease, 15% for timber purchased otherwise than through a forest lease and 35% for other forest produce. Its application was further restricted only to those persons who acquired these goods in any sale by way of auction, tender or any other mode from 'sellers' defined in explanation to Section 44AC(3) as Central Government, a State Governments or any Local Authority or Corporation or Authority established by or under a Central, State or Provincial Act, or any company or firm or cooperative society (w.e.f. 1.4.1991). Those purchasing goods otherwise were excluded except where the purchase was 'from a public sector undertaking'. Finance Act 1989 introduced a Proviso to Section 44AC(1)(a) which barred the application of the Section in cases of liquor sale where the goods were not purchased by way of an auction and the sale price was fixed by or under a State Act. After the passage of Finance Act 1988, a Press Note was issued clarifying that 'purchase price' would include excise duty, sales tax or any other levy paid by the buyer but would exclude freight or transportation charges. For liquor buyers the cost of bottle, label and sealing charges were to be included. Explanation to Section 44AC(1)(a) inserted with effect from 1.4.1991 defined 'purchase price' for liquor contractors as *amount* paid or payable excluding **the amount paid towards the bid money in an auction or the highest accepted offer in case of tender or any other mode**. Simultaneously Section 206C, was introduced providing for deduction of tax at source on the basis of profits as estimated under Section 44AC.

The Memorandum explaining the provisions in Finance Bill 1988 set out the reasons for the introduction of the Section 44AC in following words:

"**New provisions to counteract tax evasion by liquor contractors, scrap dealers, dealers in forest products, etc.** - considerable difficulty has been felt in the past in making assessment of incomes in the case of persons who take contracts for sale of liquor, scrap, forest products, etc. It has been the department's experience that for taking such contracts, firms or associations of persons are specifically constituted and very often no trace is left regarding them or their members after the contract has been executed. Persons have also been found to have taken contracts in benami names by floating undertakings or associations for short periods. Since tax is payable in the assessment years in respect of the incomes of the previous years, the time by which the incomes from such sources become assessable, such persons are not traceable. At the time of assessment in these cases, either the accounts are not available or they are grossly incorrect or incomplete. Thus, even if assessments could be made on ex-parte basis, it becomes almost impossible to collect the tax found due, either because it becomes difficult to establish the identity of the persons and trace them or because of the fact that the persons in whose names contracts are taken are men of no means. With a view to combat large scale tax evasion by persons deriving income from such businesses, the Bill seeks to insert a new Section 44AC to provide for determination of income in such cases. Taking into account the experience gained in the past regarding the ratio of profit to the sale consideration, the proposal is to provide that sixty per cent of the amount paid or payable by such persons on sale would constitute income of the taxpayers, i.e., the buyer.

The provisions of this section will apply to an assessee, being a buyer of any goods in the nature of alcoholic liquor for human consumption (other than Indian-made foreign liquor) or any forest produce, scrap or waste, whether industrial or non-industrial, or such other goods as may be notified by the Central Government, at the point of first sale. The word 'seller' connotes the Central Government, State Governments or any Local Authority or Corporation or Authority established by or under a Central Act or any company. The provisions of this section shall not apply to any buyer in the

second or subsequent sale of such goods.

This amendment will take effect from April 1, 1989, and will, accordingly, apply to assessment year 1989-90 and subsequent years. Further, with a view to facilitate collection of taxes from assessees, it is proposed to introduce a new section 206C to provide that any person, being a seller, referred to in Section 44AC, shall collect income-tax of a sum equal to twenty per cent of the amount paid or payable by the buyer, as increased by a surcharge for purposes of the Union calculated on the income-tax at the rates in force. Such sum is required to be collected either from the buyer at the time of debiting the said amount to the account of the buyer or at the time of the receipt of that amount from the buyer, whichever is earlier. This mode of recovery of tax shall be without prejudice to any other mode of recovery. The tax so collected by the seller shall be paid to the credit of the Central Government or as the Board directs, within seven days from the date of collection. It will be treated as tax paid on behalf of the person from whom the amount has been collected and credit shall be given for such amount in the assessment made under this Act on production of a certificate.

The new section also provides that if a seller does not collect or after collecting fails to pay the tax, he shall be deemed to be an assessee in default in respect of the tax and the amount of the tax together with the amount of simple interest, calculated at the rate of two per cent per month or part thereof, shall be a charge upon all the assets of the seller. A new Section 276BB provides for prosecution of a person who fails to pay the tax collected at source for a period which shall not be less than three months but which may extend upto seven years and with fine.

These amendments will be made effective from 1st June, 1988".

This measure was also described as "an anti-evasion measure" in the Budget Speech of 1988. While the Bill provided for taxable profit being estimated at 60% of the 'purchase

price' and also sought to include purchase of scrap and waste the Act as finally passed confined the coverage to liquor and timber traders and provided for estimation of taxable profits at lower rates indicated earlier. The percentage of tax to be deducted at source under Section 206C was also reduced to 10% of the purchase price for timber obtained otherwise than through a forest lease and 15% of purchase price for others as against the recommendation of deduction at the rate of 20% of purchase price in the Finance Bill.

The introduction of the section resulted in immediate legal challenge to the concept of estimation of profit as a fixed percentage of 'purchase price' on the ground of being discriminatory in nature because the profit earned would vary from person to person with some suffering loss, some earning higher profit and some lower. Creation of a fiction of fixed profit was, therefore, alleged to be plainly and manifestly arbitrary and unreasonable. It was, therefore, argued that the section constitutes an unreasonable restriction on the taxpayer's fundamental rights guaranteed by Article 19(1)(g) of the Constitution. It was also argued that it cannot be justified as reasonable under Article 19(6). The deduction at source was also challenged on the ground that it will have the effect of killing the business of persons dealing in these goods. It was also argued that there has to be income before a tax is levied. No income is derived unless goods are sold. Collection of tax at the time of purchase cannot be considered as income tax, as the goods purchased may be lost or destroyed before these could be sold. The initial challenge also was to the definition of the purchase price and it was argued that for "Arrack" it would mean the issue price without including privilege fees or licence fees, the argument being that privilege fees or licence fees represent costs for becoming entitled to purchase and are not part of the 'purchase price'.

The legal issues have been analysed in the decision of the Andhra Pradesh High Court in the case of A. Sanyasi Rao Vs. Government of Andhra Pradesh (178 ITR 31). The first point noted by the Court was that the definition of 'income' in Section 2(24) is only inclusive and cannot be read back to entry 82 in List I of the Seventh Schedule to the Constitution which empowers Parliament to make a law with respect to tax on income. This expression has to be given its natural meaning keeping in mind that the entries in the seventh schedule ought to be construed liberally. Lord Wright observed in the case of Kamakhya Narain Singh Vs. C.I.T. (11 ITR 513) that "the word 'income', it is true, is a word difficult and perhaps

impossible to define in any precise general formula. It is a word of broadest connotation". The Supreme Court observed in the case of Navin Chandra Mafatlal Vs. C.I.T. (26 ITR 758) that the entries in seventh schedule must be given "the widest possible construction according to their ordinary meaning". It was on this reasoning that the Supreme Court in the case of Balaji Vs. ITO (43 ITR 393) upheld the provisions relating to taxation of income of the wife and minor child in the hands of a taxpayer under Section 16(3) of the 1922 Act [later corresponding to Section 64(1)(iii) in I.T. Act 1961 wherein such income of the minor could be assessed in the hands of a taxpayer even if he was not a partner in the firm where the minor was admitted to the benefits]. The Supreme Court noted that in India it is a common practice to nominally take the wife or minor son in partnership so as to reduce tax burden. It was also noted that the provision was introduced on the basis of recommendations made by the Income Tax Enquiry Commission of 1936. The earlier decision in the case of Baldev Singh Vs. C.I.T. (40 ITR 605) was also quoted to the effect that entry 54 of List I of Seventh Schedule to the Government of India Act 1935 (corresponding to entry 82) should be read **not only as authorising the imposition of a tax but also as authorising the enactment which prevents the tax imposed being evaded.** Similar views were expressed by the Supreme Court while upholding the provision of Section 12(1B) of Income Tax Act 1922 providing that a loan made to a shareholder by a private controlled company is taxable as dividend (56 ITR 198 SC). In this case, the observations of Gwyer CJ in the case of United Provinces Vs. Atiqa Begam (1940) FCR 110, to the effect that 'each general word should be held to extend to all ancillary or subsidiary matters which can fairly and reasonably be said to be comprehended in it' were also noted. This approach of the Supreme Court was also underlined in the case of Baldev Singh mentioned above while upholding the provision relating to levy of super tax where the dividend distributed within 12 months following the previous year was less than 60% of the total income of that previous year unless the Income Tax Officer was satisfied that payment of larger dividend would be unreasonable considering the past losses or smallness of the profit. After recording the views already mentioned above the Court upheld the validity of this section as it dealt with a situation where the profit was deliberately not distributed.

On the basis of the above decisions of the Supreme Court, the Andhra Pradesh High Court rejected the plea that the Parliament lacked the legislative competence to enact Sections

44AC and 206C. The Court also took note of the fact that there are other provisions requiring income computation otherwise than in accordance with Sections 28 to 43A.

While considering the second objection that levy of tax on purchase price cannot be characterised as tax on income the Court took note of the decisions of Federal Court and Supreme Court in cases arising under Central Excise Laws holding that while levy of tax in India has the status of a constitutional concept, the point of collection is located where the statute declares it will be (Paragraph 14 Union of India Vs. Bombay Tyre International Ltd., 59 COMP CAS 460). In this case, the Supreme Court observed that the measure employed for assessing a tax must not be confused with the nature of tax. Reference was made to the decision of the Federal Court in the case of Ralla Ram Vs. Province of East Punjab (AIR 1949 FC 81) holding that the tax on buildings under the Punjab Urban Immovable Property Tax Act 1940 measured by a percentage of the annual value of such buildings remained a tax on buildings even though the measure of annual value of a building was also adopted as a standard for determining income from property under the Income Tax Act. Reference was also made to the case of Atma Ram Budhia Vs. State of Bihar (AIR 1952 PAT 359) wherein the Patna High Court held that tax on passengers and goods assessed as a rate on the fares and freights payable by the owners of the Motor Vehicles was not a tax on income but on passengers and goods and which was quoted with approval by the Supreme Court in the case of Sainik Motors Vs. State of Rajasthan (AIR 1961 SC 1480). The Supreme Court also referred to the decision in the case of D.G. Gouse and Co. (Agents) Pvt. Ltd. Vs. State of Kerala (AIR 1980 SC 271) wherein action of the legislature in linking the levy of tax on buildings under the Kerala Buildings Tax Act with the annual value of the buildings was upheld. The Supreme Court cited with approval a passage from Seervai's 'Constitutional Law of India', Second Edition, Vol 2, page 1258 to the effect that decided cases establish a clear distinction between the subject matter of a tax and the standard by which the amount of tax is measured. It was noted that the standard adopted as the measure of the levy may indicate the nature of the tax, but it does not necessarily determine it. Following observations of the Privy Council in a Reference under the Government of Ireland Act 1920 and Section 3 of the Finance Act (Northern Ireland)(1934AC 352) were also quoted.

"....... It is the essential characteristics of the particular tax charged that is to be regarded, and the nature of mechinary - often complicated - by which the tax is to be assessed is not of assistance, except in so far as it may throw light on the general character of the tax".

After considering the above decisions the Andhra Pradesh High Court held that by adopting purchase as a measure the tax imposed does not cease to be tax on income.

The Andhra Pradesh High Court then considered whether Sections 44AC and 206C violate Articles 14 and 19(1)(g) of the Constitution. The Court noted the observations of the Supreme Court in the case of V. Venugopala Ravi Verma Rajah Vs. Union of India (74 ITR 49): to the effect that the equal protection clause enshrined in Article 14 is not an abstract proposition. Quite often tax laws are enacted with a view to solve specific problems or to achieve definite objectives by specific remedies. In such a situation, absolute equality or uniformity of treatment is impossible of achievement. Following observations were also quoted:

"Tax laws are aimed at dealing with complex problems of infinite variety necessitating adjustment of several disparate elements. The Courts accordingly admit, subject to adherence to the fundamental principles of the doctrine of equality, a larger play to legislative discretion in the matter of classification. The power to classify may be exercised so as to adjust the system of taxation in all proper and reasonable ways; the Legislature may select persons, properties, transactions and objects, and apply different methods and even rates for tax, if the Legislature does so reasonably. Protection of the equality clause does not predicate a mathematically precise or logically complete or symmetrical classification: it is not a condition of the guarantee of equal protection that all transactions, properties, objects or persons of the same genus must be affected by it or none at all. If the classification is rational, the Legislature is free to choose objects of taxation, impose different rates, exempt classes of property from taxation, subject different classes of property to tax in different ways and adopt different modes of assessment. A taxing

statute may contravene Article 14 of the Constitution if it seeks to impose on the same class of property, persons, transactions or occupations similarly situate, incidence of taxation, which leads to obvious inequality. A taxing statute is not, therefore, exposed to attack on the ground of discrimination merely because different rates of taxation are prescribed for different categories of persons, transactions, occupations or objects.

It is for the Legislature to determine the objects on which tax shall be levied, and the rates thereof. The Courts will not strike down an Act as denying the equal protection of laws merely because other objects could have been, but are not, taxed by the Legislature".

However, the taxpayer's objection that lack of classification in Section 44AC creates inequality was found to be reasonable on the basis of the decision of the Supreme Court in the case of K.T. Moopil Nair Vs. State of Kerala (AIR 1961 SC 552). The issue in this case related to a basic tax of Rs. 2 per acre payable on all lands under the Travancore Cochin Land Tax Act 1955. In this case, the annual income from a forest taken on lease was stated to be Rs. 3,100, but the provisional assessment of basic tax @ Rs. 2 per acre worked out to Rs. 50,000. It was then held by the Supreme Court that this is one of the cases where lack of classification creates inequality. Before the Andhra Pradesh High Court, it was argued that the fixation of 40% as profit in case of "Arrack" was arbitrary, discriminatory and unreasonable. It was pointed out that in one of the districts in 1987-88 the purchase as well as sale prices were both fixed by the State government and the margin of profit was less than 10%. Even though these are not so fixed later, clearly the rate of 40% is discriminatory. The Court observed that even taking into account the difficulty relating to taxation of individuals carrying on this business, the fact that contracts are taken in the names of dummies or fictitious persons or persons of little means and even accepting that there is large scale evasion which creates a situation which has to be remedied, the remedy has to be proportionate to the evil. Once tax has been deducted under Section 206C, it was not necessary to dispense with Sections 28 to 43C in the matter of assessment. The Court observed that there is no reason behind saying that even when a person actually earns less profit, or incurs loss, his profit should be arbitrarily fixed at 40% of the purchase price and

he should be denied the right to establish his real income. Even where no books are maintained or if maintained are not proper these can be rejected and a best judgement assessment made. The level of profits in such trade in a given area, region or State can always be kept in mind while making the best judgement assessment or determining the truth or genuineness of the accounts. The Court was not convinced with the details furnished in 8 cases showing that generally the profits exceeded the percentages fixed under Section 44AC and observed that picking up 8 cases of liquor contractors from all over the country, that too of major contractors, cannot be said to be sufficient basis for such a harsh and unusual provision. The Court, therefore, held that the imposition is likely to be characterised as disproportionate and, therefore, an unreasonable restriction on the fundamental rights guaranteed by Article 19(1)(g). Instead of striking down the Section 44AC on the above basis the Court decided to read it down to make it consistent with the guarantees in Articles 14 and 19(1)(g). It was thus held that the words "notwithstanding anything contrary contained in Sections 28 to 43C" would be confined to the limited purpose of deduction of tax at source under Section 206C. Collections will be made at the rates specified in Section 206C and then a regular assessment will be made like in the case of any other assessee.

The above view of the Andhra Pradesh High Court is supported by the Punjab and Haryana High Court in the case of Satpal & Co. Vs. Excise and Taxation Commissioner and Others (185 ITR 375) and the Orissa High Court in the case of Sri Venkateswara Timber Depot Vs. Union of India (189 ITR 741). The decision of the Supreme Court is not yet available.

From the above discussion it would be seen that the Andhra Pradesh, Punjab and Haryana and Orissa High Courts are inclined to accept any measure for income determination provided it can be shown to have some connection with income. However, providing a fixed norm without any right of rebuttal is not viewed favourably. Not only this, if the accounts are unreliable the norms valid for the area, region or State where taxpayer carries on business are considered appropriate for income determination and not norms uniformly applied to taxpayers all over the country and determined on the basis of results in a few arbitrarily picked up cases.

The Kerala High Court, on the other hand, examined the issue in the case of Shri P. K.V.M. Hammed Kutty Haji and Others Vs. Union of India and Others (176 ITR 418) and upheld the constitutional validity of the provisions of the Section 44AC and Section 206C. The Court took note of the difficulty of taxing businesses where accounts are hardly kept or opportunities of manipulation are vast and wide. In such cases fiscal reforms suggest presumptive approach. A presumptive taxation is thus a substantial anti-evasion measure. It was also observed that it is the experience of the Courts of law that many of the persons who participate in auctions either in abkari articles or in forest produce are fly-by-night operators. The reports of the Excise and Forests Departments give indication of such operations and the sizeable unrealised arrears of the revenue. The Court also took note of the Finance Minister's Speech, Notes on Clauses of the Bill and the Press Communique of the Central Board of Direct Taxes and observed that these furnish enough indication about the approach and attitude of the Government. It was, therefore, held that the provisions of Section 44AC and Section 206C do not result in serious jeopardy of the Constitutional rights of the traders nor have they been subjected to discrimination. These are, therefore, within the legislative competence of the Union and are valid. This view was later reaffirmed while deciding a number of writ petitions (177 ITR 358).

While, the final view on the issue is yet to be heard the Section 44AC was omitted by the Finance Act 1992 with effect from 1.4.1993. The Explanatory Note to the Finance Bill elaborated that having regard to the controversy on the interpretation of the provisions of Section 44AC and the administrative difficulties in implementation of this provision it is proposed to delete the Section. However, Section 206C providing for collection of tax at source in respect of these cases shall continue to remain in force. Thus, the law as it stands at present is in conformity with the views of the Andhra Pradesh, Punjab and Haryana and Orissa High Courts.

Some discussion of the administrative problems involved in assessment of liquor contractors sought to be covered under Section 44AC would illustrate the need for presumptive taxation as also the difficulties faced even when such provisions are on the statute. The difficulty in making a correct assessment of profits in such cases lies in the fact that retail outlets for selling liquor are very large in number and are located in spread out

areas including highways. The persons buying liquor have no interest in taking a voucher and these are seldom issued. Sale vouchers even where produced for examination by the tax authorities cannot and do not bear any particulars of the buyers thus making any verification impossible. Collecting evidence of sale price through regular visits to all such outlets is an impossible exercise. Thus, examination of books or comparing results with the 'trend in the area, region or State' is a largely infructuous exercise. Then, there are many expenditure heads which are open to abuse. The normal assessment procedures, therefore, result in substantial under-assessment of profits and the question of capturing real income just does not arise. Introduction of Section 44AC took away the need for verification of sale price or expenses. It determined the profit on the basis of 'purchase price'. The State authorities were not averse to bifurcating the total receipts in such a manner that the excluded amounts constituted a substantial percentage of the total money paid. The case of 'Nirgam Mulya' in Uttar Pradesh State being one such instance. This affected the assessed income as also the tax deducted at source. Then, again while the Section applied to the business of sale of country liquor the State excise authorities also required the bidders to lift a specified quantity of Indian Made Foreign Liquor (IMFL). All such persons claimed huge losses in sale of IMFL which were adjusted against the presumed profits on sale of country liquor. Thus, even though the presumption under Section 44AC restricted the area of manipulation the loopholes were fully exploited. The assessments made showed sharply divergent results depending upon the comparative skills and integrity levels of the taxpayer's accountant and the tax official concerned. The provisions for deduction of tax at source on the basis of the presumption, however, ensured that some tax was collected which would be impossible in the absence of such deduction and also ensured that the taxpayer filed return to claim refund.

III.5 Elements of Presumption or Estimation in the Indian Income Tax Act

Apart from the specific provisions of the nature of presumptive/ estimated tax mentioned above, the Income Tax Act also contains provisions which have elements of presumption or estimation. For instance, in case of salary earners a fixed percentage is presumed to have been spent for earning the salary and allowed in form of standard deduction under Section 16(i). Also, Rule 3 of the Income-Tax Rules 1962 gives a fixed formula for valuing the perquisite in form of residential accommodation provided free of cost

or at concessional rent and the perquisite in form of car for personal use. While computing the income from house property 'the sum for which the property might reasonably be expected to let from year to year' is presumed to be the minimum 'annual value' under Section 23(1). There is a further element of presumption in estimating expenses for repairs at 20 per cent of the annual value under Section 24(1)(i). Similar elements of presumption can be seen in Section 36(1)(viia) applicable to Banks, Financial Institutions and State Financial or Industrial Investment Corporations which provides for deduction of 'provision for bad and doubtful debts' subject to an upper limit of 5% of total income plus 2% of advances by rural branches for scheduled banks and 5% of total income for foreign banks and financial institutions, etc. In other words, there is a presumption that out of the 'provisions for bad and doubtful debts', debts upto the specified limit will not be recovered and are, therefore, deductible while arriving at the taxable income. An identical approach has been adopted in Section 36(1)(viii) while permitting deduction of upto 40 per cent of the total income out of the amounts carried to 'special reserves' by certain financial corporations engaged in providing long term finance. Section 44C imposes an upper limit of 5% of total adjusted income, on deduction on account of head office expenses while determining the taxable income of a non-resident. This can be viewed as presuming an upper limit for such expenses. The income from Insurance business is determined in accordance with the provisions of the first schedule of the Income Tax Act. This schedule estimates income from Life Insurance as the annual average of the surplus arrived at by adjusting the surplus or deficit disclosed by acturial valuation made in accordance with the Insurance Act 1938 in respect of last income evaluation period ending before the commencement of the financial year.

Income derived from sale of tea grown and manufactured by a seller in India is part from Agriculture and part from business. Under the powers vested with the Board by virtue of Section 295(2)(b)(i), Rule 8 has been framed providing that 40% of such income is deemed to be income liable to tax. Thus income from business is estimated at 40% of the total income from this activity, the balance being treated as income from agriculture and therefore exempt.

The presumptions or estimations in the foregoing provisions simplify the accounting requirements for the taxpayers and make the task of tax administration easier by taking away the need to test the correctness of such accounts. There is, however, one provision which was introduced not as a result of any administrative difficulty either for the taxpayer or the tax administration but out of the need for a more equitable application of the economic principle of levying tax according to 'ability to pay'.

III.6 Minimum Tax

Section 115J introduced by Finance Act 1988 with effect from 1.4.1988 was the Indian version of a minimum tax on corporations. It provided for computing minimum taxable income at 30% of the 'book profits' on the basis of accounts prepared in accordance with the relevant provisions of the Companies Act and adjusted to disallow income tax, amounts transferred to reserves and provisions and unascertained liability, provision for losses of subsidiary companies, etc., debited to the Profit and Loss Account. The disallowances excluded liabilities relating to expenditure otherwise deductible and which had been incurred or accrued. Such adjusted amount was reduced by the amounts withdrawn from reserves, or provisions if any such amount was credited to the Profit and Loss Account and brought forward losses or unobserved depreciation which would be required to be set off against profits of that year as if provision of Section 205(1)(b) of Companies Act 1956 were applicable.

The ambit and object of the New Provision was elaborated upon in Board's Circular No. 495 dated 22.9.1987 in following words:

> "New provisions to levy minimum tax on 'book profit' of certain companies -
> 36.1. It is an accepted cannon of taxation to levy tax on the basis of ability to pay. However, as a result of various tax concessions and incentives certain companies making huge profit and also declaring substantial dividends have been managing their affairs in such a way as to avoid payment of income tax.

36.2 Accordingly, as a measure of equity, Section 115J has been introduced by the Finance Act. By virtue of the new provisions, in the case of a company whose total income as computed under the provisions of the Income Tax Act is less than 30 per cent of the book profit computed under the Section the total income chargeable to tax will be 30 per cent of the book profit as computed.

36.3 Section 115J, therefore, involves two processes. Firstly, an assessing authority has to determine the income of the company under the provisions of the Income Tax Act. Secondly, the book profit is to be worked out in accordance with the Explanation to Section 115J(1) and it is to be seen whether the income determined under the first process is less than 30 per cent of the book profit. Section 115J would be invoked if the income determined under the first process is less than 30 per cent of the book profit. The Explanation to sub-section(1) of Section 115J gives the definition of the 'book profit' by incorporating the requirement of Section 205 of the Companies Act in the computation of the book profit.

Brought forward losses or unabsorbed depreciation whichever is less would be reduced in arriving at the book profits. Sub-section(2), however, provides that the application of this provision would not affect the carry forward of unabsorbed depreciation, unabsorbed investment allowance, business losses to the extent not set off, and deduction under Section 80J, to the extent not set off as computed under the Income Tax Act.

36.6 These amendments will come into force with effect from 1st April, 1988, and will, accordingly, apply in relation to the assessment year 1988-89 and subsequent years".

Thus even when income was computed U/S 115J, the depreciation investment allowance and permissible deduction U/S 80J, to the extent remaining unadjusted, were permitted to be carried forward as in other cases.

The need for this Section arose as the Income Tax Act 1961 provided for liberal depreciation and investment incentives. Even now it permits depreciation on the basis of written down value whereas under the Companies Act straight line method is also permitted. The rates of depreciation are higher than those under the Companies Act. Some of the assets qualify for 100% deduction. These liberal provisions create substantial gap between the book profits computed under the Companies Act and the taxable income computed for payment of income tax. Thus, companies earning huge book profits and declaring substantial dividends could show nil taxable income. Introduction of Section 115J ensured that the income tax was paid according to the actual 'ability to pay'.

The Section was amended by the Direct Tax (Amendment) Act 1989 to exclude companies engaged in the business of generation or distribution of electricity. The profits derived from business of export or from services provided to foreign tourists by approved hotels or tour agents or travel agents were also excluded as these qualified for 100% deduction under Sections 80HHC and 80HHD. The provisions of Section 115J took away the 100% exemption and this anomaly was accordingly corrected. The scope of these amendments was explained in Board's Circular No. 559 dated 4.5.1990 and the changes became effective from the Assessment Year 1989-90.

A large number of companies interpreted the provisions to mean that where the accounting year is different from the previous year under the Income Tax Act (i.e., the period ending on 31st March), the provisions of Section 115J do not apply. Since this was against the legislative intent, sub-section(IA) was introduced by the Finance Act 1989 with effect from 1.4.1989 requiring the companies to prepare Profit & Loss Account in accordance with the provisions of Part II and Part III of the Sixth Schedule to the Companies Act 1956.

The provision regarding adjustment of net profit by way of reduction by the amount withdrawn from reserves or provisions was used by some companies to reduce their net profits by the amounts so withdrawn even though the reserve when created had not gone to increase the book profit. This again conferred an unintended benefit. To counteract this the Finance Act 1989 provided that deduction would be allowed only where the reserve was

created prior to 1.4.1988 or if created later increased the book profit in any year when the provisions of Section 115J were applicable. This amendment came into force with effect from 1.4.1988.

Section 115J was subject matter of criticism[1] on the ground that the Income Tax Act on one hand provides incentives to industrial development by way of allowances and deductions but at the same time takes away from one set of assessees the full benefits thereof for the only reason that their book profits as reflected for a different statute show a different position. Writs were also filed in Bombay and Karnataka High Courts but no decisions are available. The main problem faced in implementation related to the interpretation of Clause (iv) of Explanation to Section 115J which provided for adjustment of brought forward loss or depreciation which would be required to be set off against the profit of the relevant previous year as if the provision of Section 205(1)(b) of the Companies Act 1956 were applicable. Depreciation is adjusted against current year's income only to the extent of the income and the balance is carried forward indefinitely in view of the provisions of Section 32(2) of the Income Tax Act 1961. As against this a business loss is carried forward for only 8 subsequent assessment years under Section 72(3). Thus business loss and unadjusted depreciation are treated as distinct and separate from each other by the assessing officers. Under Section 205(1)(b) of the Companies Act 1956 adjustment is for the brought forward loss or the depreciation whichever is lower. The difficulty arose as the assessing officers took 'brought forward loss' as distinct and excluding the 'brought forward depreciation' whereas the companies took the view that loss would include unadjusted depreciation and as such in all the cases the effective deduction would be the sum total of the two. This issue was discussed by the ITAT, Hyderabad in a group of cases including Sorana Steel Private Limited Vs. Dy. Commissioner of Income-tax (Asstt. - III [201 IRT 1(AT)] where it was held that the loss as mentioned in Section 115J refers only to the net loss after deduction of depreciation. However, this decision was reversed by the Andhra Pradesh High Court (207 ITR 508). The High Court held that interpretation of "loss" and "depreciation" for the purpose of declaring dividend under the Companies Act 1956 was irrelevant and their interpretation under Clause (iv) of Explanation of Section 115J should be in accordance with

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[1] Law of Income Tax, Sampati Iyengar pp. 3708.

the provisions of Income Tax Act. The Court, therefore, held that for the purposes of Section 115J of the Act, loss does not include "unabsorbed depreciation". Thus, the Andhra Pradesh High Court has upheld the view of the Income Tax Department.

Section 115J was deleted by the Finance Act 1990 w.e.f. 1.4.1990. The explanatory notes clarified that:

> "The provisions had been enacted to restrict the erosion of the base of taxable income on account of large number of concessions. In view of the package of measures proposed for rationalising the tax structure including discontinuance of certain investment incentives in respect of future investment, which will now have the effect of increasing the taxable income base of an assessee, there is no further necessity of retaining the provisions of Section 115J on the statute. Accordingly, it is proposed to amend Section 115J to provide that its provisions shall not apply to any assessment year which commences on or after the 1st day of April, 1991".

Thus, the minimum tax imposed under Section 115J related to the actual income earned by a company and was levied on year to year basis with no adjustment against income tax computed on the basis of regular assessment, in excess of the minimum tax, in past or future years. It was neither presumptive nor estimated tax but an alternative minimum tax on the lines of the provisions existing in USA and Canada though much less complicated.

The Indian experience with presumptive or estimated system of income taxation has been limited in its scope as compared to what has been tried in other countries. The most systematic and extensive effort has been in form of the system of 'Forfait' in France and the system of 'Tadrich' in Israel. This is discussed in Chapter IV.

CHAPTER IV

USE OF PRESUMPTION IN FRANCE AND ISRAEL

IV.1 System of Forfait in France[1]

IV.1.1 Income-tax System: The Income-tax System as it exists today in France has four components, namely:

a. Forfait for very small business with turnover upto 70,000 FFs.

b. Forfait for others upto turnover of -

   i. 5,00,000 FFs for 'commercial business' involving buying and selling of goods.

   ii. 1,50,000 FFs for 'commercial business' by those providing services. Artisans like carpenters, hairdressers, etc., fall in this category.

   iii. 1,75,000 FFs for 'non-commercial' profits of 'liberal professionals', i.e., doctors, architects, lawyers, etc.

c. Real Simplified System for enterprises with turnover upto 30,00,000 FFs, and

d. Real normal system for enterprises with turnover above 30,00,000 FFs.

IV.1.2 Forfait

a. Background. The term 'Forfait' is legally defined as profit which an enterprise is normally expected to earn. The system of 'Forfait' is, therefore, a system of assessment of 'normal profits' and not the actual profits.

Historically, the introduction of the system in 1949 was the result of difficulty in taxing the farmers who had no idea of accounts and were 'incapable from the point of view of Taxes'. Professional unions were involved. National Federation of Union of Farmers was the principal organisation. Over the years the importance of this Federation has declined. Also the farmers and those earning 'non-Farm' income are now better trained in accounts. The turnover limit has remained unchanged since 1968. As a result the numbers falling under the "Forfait" system has declined. The number of farmers under 'Forfait' system stands reduced from about 10,30,000 to 6,05,382 in the last ten years. Those covered under the system are about 75 per cent of the total but their revenue contribution is only about 20 per cent of the contribution by all Farmers. The exact figures for non-farm income could not be ascertained but the impression given is that the coverage of the 'Forfait' declined from year to year and is now insignificant. In the one Unit in Paris which was visited, out of 3,700 cases only about 200 cases are covered under the system.

The 'Forfait' system continues as 'there is some satisfaction over the fact that small enterprises are encouraged to pay some tax and there is contact with such enterprises once in two years'. Politically this group is difficult to control in any other way. Continuation of 'Forfait' enabled maintenance of 'fiscal peace' and satisfaction for the State as collection of some tax is better than nothing.

b. Coverage. The application of 'Forfait' is on the basis of turnover of the enterprise carrying on business including **that** of **agriculture.** Companies, Charitable Institutions, Builders including those buying and selling property and Importers are among those excluded. For others, once the turnover is below the prescribed level, the case is automatically taken up under the system. The individual has right to opt for assessment under the 'Real Simplified System' provided proper books of accounts as required under that system are maintained. Whenever the turnover level crosses the prescribed limit, the case continues under the system for one year before being changed to the next higher system in the second year.

c. **Book-Keeping requirements**. Only cash accounting is required. The emphasis is on maintenance of purchase register with vouchers for those carrying on business of buying and selling and receipt register for those providing services and 'liberal professionals' like doctors, lawyers, architects, etc.

d. **Filing of returns**. The Return Form requires information relating to number of persons living with the individual, their incomes and cars owned, etc. In addition information relating to purchases, stock, sales, expenses and the staff has to be furnished. The form calls for specific information relating to the standard of living of the family unit and the commercial activity but does not contain any declaration of income. The declaration is filed once in two years. Calendar year is the accounting year. The return has to be filed by 15th of February. The return form has separate pages wherein first and second estimates of income are recorded, the third page has finally agreed income while the fourth is used for statistical purposes.

e. **Income determination**. The process of income determination of 'non-Farm' income begins once the declaration is filed by 15th of February of the subsequent year. The process involves individual discussions between the taxpayer and the tax official who is of the level of 'Controller'. The starting point for determining commercial profits from trading activity is the figure of purchase. The turnover is determined by applying a 'co-efficient'. The 'co-efficients' are based on the "Monographies" prepared for different regions and for different business activities which are made available to all tax officials. The estimate of expenses is based on the nature and extent of evidence available with the taxpayer and discussion with him. Where no "Monography" is available the 'co-efficient' is decided on the basis of tax records of the particular taxpayer as also 'informal discussions with the other colleagues who may have expertise in the particular business'. Normally, the process of discussion is completed by the end of May.

For instance, if in case of Grocer, the declaration in February 1994 shows purchases at Rs. 1,50,000.00 and expenses at Rs. 50,000.00 for the accounting year 1993, the Inspector will proceed to check the reliability of figures of purchases and expenses with available vouchers.

In case these are 'justified' no change will be made. The turnover would be determined on the basis of 'co-efficient' indicated in the "Monography". The 'Monographies' generally give a range for the co- efficient and the inspector picks up the co-efficient on the basis of the location of business or other related factors. If in the instant case the co-efficient considered appropriate is 2 the working under 'Forfait' for Income-tax and V.A.T. would be as follows:

	Rs.	Value Added Tax
	Rate	Amount
Turnover	3,00,000 (1,50,000 X 2)	A
Purchase	1,50,000	B
Expenses	50,000	C
Profit	1,00,000	---------
Income-tax on Profit	X	Y (A-B-C)

This would constitute the first proposal from the 'Controller' regarding the Income-tax and VAT payable by the Taxpayer. On receipt of the first notification the taxpayer has 30 days to respond. He will sign if the estimate is accepted. If not, he will return the notification unsigned. The individual may accept one estimate, while objecting to the other.

The most common objection at this stage is in regard to the co-efficient. In the example given above, the individual may argue that the co-efficient is excessive as there was recession and it should be 1.5. This results in further negotiations. The inspector then sends an estimate. The taxpayer has 10 days to accept or reject this offer. At this stage, in most of the cases, an agreement is reached. In less than one per cent of the cases the estimate is disputed.

Once income has been agreed for the year 1993, this process will not be repeated for the year 1994. The agreement will include estimate of income for the year 1994. Thus, the agreement under 'Forfait' is for two years, i.e., the year for which return is filed and the year in which it is received. The estimate for the later takes into account rate of inflation and scope of development of the business. This agreement can continue for the next two years unless the taxpayer claims that the estimate would be higher or the tax officials feel that it would be lower. In most of the cases negotiations are repeated every two years as the Tax Administration feels that there is need for upward revision in view of development of business and inflation. In other words, if there are 2,50,000 businesses, the process of 'Forfait' would be undertaken for 1,25,000 businesses every year on an average. Where the business is discontinued the income is taken as proportion of the estimate for the full year. Where it is closed even before the agreement for that year can be reached, the estimate of the preceding year is applied. Where the individual also earns salary income the estimate arrived at as above is added to his salary income and taxed accordingly. In the case of 'liberal professionals' the income determination is done every year and not every two years for 'historical though not good reasons'.

No loss can be shown under the System. The 'liberal professionals' cannot claim deduction for unrealised fees.

For farm income, there is no individual discussion and the income determination is on the basis of 'Collective Forfait' which is based on extensive survey of the nature of land and nature of crop grown in each of the 99 Administrative Units called 'Departments' which cover the country.

For small businesses with turnover of 70,000 FFs or less, the process is further simplified and the income is taken at 50 per cent of the turnover. Normally, such a business is not enough to sustain a family. The category of taxpayers falling in this group are, therefore, mostly salaried persons doing small business on the side.

f. <u>Assessment guides and monographies</u>. Assessment guides are prepared by the officials of the 'National Department'. These are broad based and contain an indepth analysis of the economic and legal aspects of the relevant economic activity. Areas where frauds could be committed are outlined on the basis of actual detection of frauds. The Guides also contain complete details regarding prices and their evolution. The areas covered by these guides are those where regional disparity is minimal. Guides covering Banking Activity, Automobile Industry and Petrol, etc., have been prepared. Technical sheets called 'mini guides' are also brought out which confine themselves to giving details about the actual frauds. Such 'mini guides' have been prepared for businesses relating to purchase and sale of 'oysters', 'mussels' and manufacture of iron and steel products, etc. There is no talk of 'co-efficients' for determining turnover in these Guides. When a case is picked up for detailed investigation these assessment guides are utilised for deciding the areas to be investigated.

Monographies, on the other hand, are prepared at the regional levels by the Principal Inspectors and relate to various business activities of the Region. These Monographies give details of various 'co-efficients'. In actual working it is the Monography which is referred to by the 'Controller' or Inspector while looking at every case including those covered under 'Forfait'.

Assessment Guides and Monographies are prepared through extensive field surveys by tax inspectors and examination of vouchers relating to purchase and sale. Those carrying on similar activities in different areas are picked up on sample basis for the purpose of such surveys. Professional organisations are sometimes involved. Some of the Inspectors working in the field and handling cases of the type under Study also assist. Information available through the trading organisations is utilised. The records of those covered by the Real System are also seen. The collective data is carefully scrutinised and normal methods like regression, etc., are used.

On the technical aspects of the Studies from statistical point of view, it was not clarified how all the businesses of the category picked up for a Study are originally listed, how the sample is selected, what is the size of the sample and how the information is collected. Method

of integration of information obtained through Survey, with the information collected through records could also not be ascertained.

Some of the officials while describing the Studies conducted by the National Department mentioned collection of data relating to sale and purchase and estimation of turnover as a function of salaries received by employees. However, from the discussion with other officials and in the field unit, it is clear that the co-efficients are not indicated in the Assessment Guides and are contained only in Monographies.

For instance in one of the Monographies restaurants are segregated into different kinds. For the ordinary and cheap types of restaurants, the Monography determines the co-efficient range of 1.6 to 2.3. Generally co-efficient of 2 is applied. Separate co-efficients are determined for fast-food, 'GASTRO' and middle class restaurants, etc. For enterprises manufacturing and selling furniture a co-efficient of 2.4 is generally used. In building construction activity there is separate co-efficient for the number of labourers and purchases depending upon their nature. For instance turnover of 1,00,000 FFs per year may be estimated for each worker and for purchase of cement and bricks a co-efficient of 1.25 may be prescribed. If, therefore, there are three workers and purchases of cement and bricks amount to 1,00,000 FFs, the turnover will be estimated at 4,25,000 FFs (1,00,000 X 3 + 1,00,000 X 1.25). In the course of discussion between the taxpayer and the tax official, the co-efficient may be marginally modified. For instance, in this particular case the turnover per labourer may be taken at 2.8 or 2.9 times the turnover per labourer as given in the Monography. The Monographies also give the fiscal legislation relevant to assessment of the business.

The Assessment Guides are meant for internal use of the Department and are treated as 'Confidential'. On the other hand Monographies are also referred to the trading organisations.

g. Advantages of forfait to the taxpayer and administration. For taxpayer there is distinct benefit as declaration is not required to be filed every year. Thus cost of compliance is halved. The book-keeping requirements are simple. The taxpayer can claim that the income

earned is less than that agreed. However, such a claim is rare and it cannot be accepted without support of proper books of accounts. The main advantage to the taxpayer is that income earned over and above that agreed is not taxed.

For the Administration the main advantage is that at least some tax is collected from a group which is politically difficult to tax on the basis of actual income. The system ensures some control once in two years.

h. <u>Incentive for going out of the system</u>. The main incentive for moving out of 'Forfait' and to the Real Simplified System is stated to be the refund which can be claimed for VAT on the investment in machinery used for agricultural activity.

A comparatively not so well-known Institution called "Register General Centre", was also cited as one of the incentives for moving out of the system of 'Forfait'. These Centres are Associations of business enterprises created by Chambers of Commerce in various Regions with the approval of the State. The objectives of the Centre include advising small enterprises in all aspects relating to Management, commercial activity, Finance and Accounts. The Membership of the Centre is open to enterprises, other than Corporations, carrying on activities of commercial or non-commercial nature including agriculture and which are taxed under the Real Simplified or Real normal systems. Those covered by 'Forfait' cannot become members of such Centres. An eligible member of the family can become a member in his/her own capacity. Thus, where a daughter is running a boutique and the father is an employee, the daughter only can become a member of the Centre. Apart from providing advice to the small entrepreneurs, the activities of the Centre include inspecting declarations of the members. Such inspection is based on the contract between the enterprises and the Centre. The Statute of the Centre authorises such scrutiny. The Law also provides that the Centre would verify the declarations of the members. There is, however, no power to ask for proof or investigation. The above activity is conducted through employees recruited by each Centre. These are generally individuals with qualifications in Management and fiscal matters. In case of detection of any irregularity the enterprises are informed and asked to ensure that necessary rectification is made. If there is refusal the

membership of the enterprise is revoked. The Centre is held responsible for ensuring that commitment to 'good faith' is kept by the members.

A tax Inspector visits each Centre to provide clarifications on different matters which may be sought by the members. The Inspector also takes up a few files to check. This way he is able to ascertain the anomalies if any detected by the Centre. All Centres are registered for three to six years by the Administration. Before renewing registration, there is again a complete check of the activities of the Centre. Administration can insist on change in the management of the Centre in case of failure to perform.

A deduction of 20 per cent from the income is permitted to all the members upto a specified level of income. The enterprises with higher income can become members but are not entitled to this benefit. Those covered by Forfait only get the benefit of services from the Centre but no deduction.

The entire cost of the Centre is met through members' subscription and the State does not contribute any funds.

The Centres were created under the authority of the law as enacted in 1970. The first Centre came up in 1976. A study on the functioning of the Centre shows that there was improvement in contact between the tax Administration and the enterprises and the Centres contributed to improvement in management of the smaller enterprises. Regarding the declarations of the members, the study took the view that this aspect needs improvement.

The setting up of Centres does not affect the working of the tax administration in form of reducing its workload as declarations are checked in the same manner as those of non-members. The 20 per cent deduction is given to bring parity with the salary earners who are entitled to such deduction in computation of their taxable income.[2]

i. <u>Appeal procedure</u>. Cases of disagreement go before a Commission which is presided by a Judge. The members of the Commission are tax officials nominated by the Director. Representatives of the trade picked up by the taxpayer in consultation with the Chamber of Commerce are also present. These Commissions are constituted for different administrative areas which are referred to as "Departments". The decisions of the Commission if disputed go before a "Tribunal". There is one Tribunal for two or three Departments. The Tribunals are of two types. Administrative Tribunal deals with conflicts with the Administration and the Legal Tribunal deals with Civil and Criminal cases. The decisions of the Tribunal are open to challenge in "COURT D' APPEL", which is equivalent to the High Court in India. The final Court is "Conseil D' ETAT" which corresponds to the Supreme Court of India.

IV.1.3 **Tax on the Basis of External Signs of Wealth:** In literature there is reference to the provisions relating to computation of income-tax base on the basis of External Signs of Wealth. Under this system the income is imputed on the basis of fixed formula for each asset like residence, cars, yatches, etc., owned by the individual. The details of the assets and the income imputation are as follows:

Elements of Taxpayer's Way of Life		Tax Base
a.	**Principal Residence**	
	Rent controlled	5 times rental value
	Not rent controlled	3 times rental value
b.	**Secondary Residence**	
	Rent controlled	6 times rental value
	Not rent controlled	3 times rental value
c.	**Resident Domestic**	
	Servant	F 6000-9000 each depending on age and sex

d.	**Motor Cars**	dependent on value
e.	**Yatches & Pleasures Boats**	dependent on size
f.	**Private Aircraft**	F 150 per French horsepower
g.	**Race Horses**	F 6000 each
h.	**Hunting Rights**	rent paid

If taxpayer has at least 5 elements whose total exceeds F 15000 for two consecutive years and is 1/3 more than reported income, Revenue may tax on the basis of 'External Signs of Wealth'.

In the course of discussions it was stated that the provision is still in existence. But, application of this provision though liberal earlier has become increasingly difficult since 1986. On an average only two cases per year are decided in this manner. Those earning income from illegal activities remain the main target.

IV.1.4 Minimum Lumpsum Tax: A Minimum Lumpsum tax is also applied on Corporations who are showing losses. If Corporation tax is payable, Minimum Tax is adjusted against the same.

IV.1.5 Administrative Set Up And Assessment Procedure: The Tax Administration is headed by a 'Directeur'. Under him there are four Divisions which look after the work relating to Companies and other businesses, personal income-tax, VAT and international relations. Each of these Divisions has a number of 'Bureaus' which look after various taxes. For instance, Bureau D-1 in Division D deals with VAT on agriculture whereas Bureau C-2 in Division C deals with taxation of farm income.

The Field set up consists of Tax Centres each headed by a Chief Inspector. Each Chief Inspector has three units working under him. Each of the Units is headed by an Inspector who has one to three 'Controllers' and four to five 'Tax Agents'. The Tax Agents are not involved

in the qualitative work and are generally engaged in putting the data from the Returns on the Computer. In case any discrepancy is noted no action is immediately taken except in case of minor arithmetical errors which are rectified. Cases of significant variation are taken up for checking by the Inspector or Controller concerned. The Controllers look after the cases in the 'Forfait System' on their own and handle other cases under the supervision of the Inspector. The Inspectors are responsible for organising the work of the Unit and also control important files. They also take up checking in cases where serious variations are detected. Such checking is, however, rare. In the Unit visited the Inspector had picked up only two such cases in the year. The investigation is through a visit of the Inspector to the business premises. The taxpayer is not called to the Office.

Normally workload in a Unit is about 1200 files and the average work per person is about 100. The discretion to pick up the case for scrutiny is entirely of the Inspector with the approval of the Principal Inspector or his deputy. The cases picked up are those with wide variation in co-efficient, delay in filing of the declaration or those relating to persons who are working without proper work permits. The work among the Units is organised on the basis of the nature of income and also geographical area. These Units are concerned only with income determination. The work of collection is handled by a separate set up which, according to the officials, 'reduces scope of corruption'.

IV.2 Presumptive Income Taxation in Israel[3]

IV.2.1 Income and Corporation Tax Rates: The maximum marginal rate of income tax on individuals and corporations was reduced from 60 per cent to 50 per cent and 61 per cent to 41 per cent between 1986 and 1992. National insurance payments declined from 21 per cent to 13 per cent during this period. On the other hand, VAT rates increased from 15 per cent to 18 per cent. This resulted in share of indirect taxes increasing from 40 per cent to 55 per cent. However, in 1993 share of direct taxes increased to 48 per cent as VAT rate was reduced to 17 per cent. The tax rates for individuals as of October 1993 consisted of five brackets of 20, 30, 35, 45 and 48 per cent. The maximum marginal rate of 48 per cent being applied to income

above NIS8690.[4] There is no exemption limit but there is a system of tax credits as a result of which no tax is payable below a threshold. For unmarried persons the threshold in October 1993 was NIS1497 per month. This is approximately 10 per cent more than the minimum wage and against per capita GDP of NIS39000 approximately in 1993.

In 1994 the income tax rates have been set at 15 per cent to 50 per cent. The corporation tax rates stand reduced to 38 per cent in 1994 and will reduce further to 36 per cent in 1996.

IV.2.2 **Tax Administration:** Income tax administration is headed by a commissioner. Under him a number of divisions look after different functional areas like, Assessment, Legal, Professionals, Internal audit, Investigation, Property tax, collection and Administration. The work of audit supervision and economic department is done within the professional division. This set-up is called 'National office'. The total strength of officers is about 600 in the National office.

The field structure consists of 22 offices. The biggest offices are in Tel-Aviv, Haifa and Jerusalem. Each office has a number of Links. These are headed by an officer with 3 or 4 inspectors. Each Link specializes in a particular industrial or trade activity. In Tel-Aviv for instance one Link looks after salary earners while another looks after large companies. Large companies include banks, insurance, shipping, airlines, companies on stock exchange, important group of companies as also the companies getting major tax relief.

IV.2.3 **Jurisdiction:** Tax returns are filed in the income tax office of the area. These are allocated for audit to the Link having expertise in the line. The head of the Link can assign the case to any of the inspectors in the Link. In practice the case is likely to be assigned to the inspector who handled it earlier. However, there is no system of fixed jurisdiction and the case may be assigned to any inspector. The inspector is concerned only with tax audit and is not involved in post audit activities like appeals or collection.

IV.2.4 Return Filing: A basic return form is filed by all taxpayers. In addition there are 40 to 50 forms which are required under different circumstances. For instance, Additional information has to be filed on separate forms whenever there is sale of machinery or benefit of inflation indexation is sought, etc. **All individual taxpayers are required to file property statements once in four years.** The requirement to file tax return is based on existence of business and not on whether profit in excess of the exemption limit is earned. Tax authorities have to be informed of closure of business. Only then liability to file the return ceases.

The business year is the calendar year. Returns are required to be filed in the month of April by self-employed and in May/June of the following year by companies. Under the exceptions allowed by the commissioner of income tax, the wage earners not having any other income are not required to file return. In 1993 about 360,000 returns were received. Out of these about 60,000 were from corporations. Further about 200,000 contributed significant revenue. These are called 'Active files'. Others with small revenue effect numbered 160,000 approximately. The wage earners not filing any return were about 1.7 million.

IV.2.5 Selection for Audit: The Active files are picked up once in three years and others once in eight years. The National office selects one third of the cases. This would cover the important cases. The inspectors pick up the remaining two third in conformity with criteria fixed by the National office. The inspector makes his selection in the month of January and the National office in the month of October. The basis of the selection is the record upto the preceding year. Current returns are not taken into account. Once a case is picked up for audit current year's return is also taken up and audited. The number of back years taken up depends on the case. The latest available data showed that on an average 2.4 years are picked up for audit. The selection for audit is computer based. The law permits scrutiny of five years. In case of concealment there is no time limit.

IV.2.6 Audit: There are three types of audit - 'Very superficial', 'Superficial' and 'In-depth'. The returns showing growth of taxable income in excess of rate of inflation or otherwise considered satisfactory are subjected to very superficial scrutiny which is similar in scope as the

'processing' done in India. The superficial audit takes into account the Tadrich if available and third party information. Mis-match with either of these results in the income being estimated at higher figure. On an average the time taken for this audit is one day. The cases with serious inconsistencies are subjected to in-depth audit. This involves visit to the business premises, examination of books, family income and wealth, bank activity, expenditures in addition to third party information and Tadrich. Cases where criminal activity is detected are referred to the Investigation wing. On an average one week's time is taken for in-depth audit.

Most of the cases get settled on the basis of consensus. Where disagreement persists the case goes to the court. Invariably the inspector brings the facts to the notice of the National office in such cases prior to the reference to the court. Complicated or otherwise important cases are also referred to the National office. The National office has only an advisory role. However, it comes into action in audits relating to very powerful or influential groups and also where gross mismatch of contribution to GDP and income-tax payment is noticed. Examples of 'Kibbutz' and diamond merchants were frequently cited in this regard. Disputed tax is not paid. If upheld by court this payment has to be made along with interest. In 1993, 4,000 to 5,000 returns were subjected to indepth audit and 70,000 to 75,000 cases were subjected to superficial audit of either type.

IV.2.7 **Book Keeping Requirements:** Each area of economic activity is carefully studied and books required to be maintained by each category are specified. This work is done under the supervision of an Assistant Commissioner. The Treasury Ministry brings out 'Rules for conducting Books' every year. These define different books in the first chapter. For each book it specifies how to keep it and what must be included. The second chapter specifies the books which have to be maintained by each category of business. The book keeping requirements are based on whether it is an industry or business and whether it is a wholesaler or retailer. There are in all ten different categories for this purpose. These are contractors; professionals other than doctors; doctors; driving schools; real estate agents; car agencies; other services; agriculture; gas stations; insurance companies and diamond trade. The turnover level and number of workers also determine the nature of books to be kept. Double entry books are required where

the turnover exceeds NIS 4 million. For lower levels and also where number of workers is less the requirement is less with single entry books being prescribed. At the lowest level only the record of daily gross income and expenditure is necessary. Empirical studies are conducted before fixing the requirements so that inspectors have no problems in inspections. The Assistant Commissioner is responsible for ensuring compliance with these rules. For this purpose surveys are conducted in accordance with a pre-planned program. Whether tax is paid or not is not a consideration for survey, but this detail is obtained in the course of survey. The disabilities attached to non maintenance of prescribed books include:

a. Rejection of accounts.

b. Additional Tax of 10 per cent or, if the default persists in next year, 20 per cent.

c. Denial of Tax credit for medical payments.

d. Interest on borrowings for payment of tax or preparing return not allowed.

e. Right to inflation indexation denied.

f. No government agency, statutory body, state or local authority, public body can enter into transaction with the taxpayer unless certified that books are maintained as prescribed, and

g. Claim of loss is not accepted.

Trade organizations were consulted earlier. The practice has been stopped and the books are prescribed on the basis of department's own research.

The question whether books as maintained are proper if disputed can be referred to a committee which has professionals of repute as members. The decision of the committee is final. It cannot be raised again in the court. The reference to the committee is at the instance of the taxpayer. Where a taxpayer feels that books as prescribed cannot be maintained by him he can approach the 'Exception Committee' under the Commissioner. The decision of this committee is also final.

It is for the inspector to show that proper books are not maintained. Cases where cash book and ledger are maintained with vouchers but there is not order book or inventory register as prescribed would fall in this category as also the cases where all books are maintained but there are inconsistencies or mis-match between consumption of raw material and output.

IV.2.8 Tadrich (Pronounced as Tadrikh)

IV.2.8.1 **History:** The concept of what was then called Tahshiv (pronounced as Takshiv) originated in late fifties/earlier sixties when the income tax administration in Israel was 'not efficient'. There was huge back log of pending returns requiring audit, the inspectors lacked technical background or expertise and there was widespread dis-satisfaction with high income estimates. The process of preparing 'Tahshivs' was then started to improve the competence of the inspectors and remove taxpayers grievances. From a stage of organizing resistance to payment of taxes the trade organizations were involved in the process of fixing the norms and book keeping requirements. Once the habit of book keeping was established the concept of Tahshiv gave way to the present day Tadrich. Tadrich is a more comprehensive document which contains the data normally compiled in Tahshiv in part two. The Tadrich is a more flexible document than the Tahshiv and enables an inspector to estimate the income closer to the actual circumstances of the taxpayer.

IV.2.8.2 **Contents:** The income determination in a case picked up for audit starts with the inspector referring to Tadrich prepared by the economic division of the National office. At present 140 such documents are available. Each Tadrich has four parts.

The first part contains a comprehensive study of the particular industrial sector giving details of each process involved from the stage of basic inputs to final outputs. It also gives details about the sources of supplies of the inputs including plant and machinery right from the first stage and the destination of the output till the final stage of local retail sale or exports. The information in this part equips the inspector with a thorough knowledge of the sector so that in his enquires and interaction with the taxpayer he is able to talk as an expert talking the language

of the sector. The taxpayer is thus less likely to make incorrect statements than would be the case if the inspector lacked such knowledge.

The second part gives the relevant numbers for income determination. Factors obtainable from independent reliable sources which could be used as indicators of profits are enumerated. Where turnover cannot be reliably determined from books factors for its determination are identified. For example location and number of employees would be the factors for determining the turnover of groceries, restaurants, cafes, barber shops, etc. In case of carpenters, garages or building contractors skill levels of employees would be relevant. For trucks and taxis turnover is determined on the basis of fuel consumption. For printing houses the type of machinery and its usage would indicate the turnover. Percentages of gross profit and wastage are determined. Generally, the figures given are not absolute but a range is given. From the information which the inspector gets from a particular taxpayer he is readily able to fix the income within the range.

The third part outlines the areas which should be investigated. Thus for jewellery stores investigation of those making moulds provided easier source of information as their number is limited whereas the number of jewellers is large. Thus enquires are targetted at specific areas.

The fourth part contains a number of forms in which once the required figures of a taxpayer are filled the costs of inputs and the quantity and price of output are readily determined. For each business there may be as many as 10 to 12 forms.

Thus for restaurants turnover per waiter is given for different categories and locations. The number of chairs and tables are taken into account. Average time spent by customers and average payments are studied to fix revenue per waiter. However, total revenue is not the multiple of this average with number of waiters. It is a lesser multiple. The exercise is done separately for different types of restaurants, i.e., neighbourhood or posh, Chinese or Indian, etc. A fixed ratios of waiters to cooks is assumed. Number of workers is carefully determined with reference to actual time worked. Young boys are counted as half and husband and wife team as

1.5 worker.

Turnover is estimated on the basis of number of workers for hairdressing saloons also. For petty contractors no distinction is made for the skill level. Where outside fabrication is done this is converted to equivalent number of workers.

In actual practice the number of workers is contested on grounds such as inefficiency or relative forced to be employed. Sometimes no salary is paid to waiters and their number is sought to be excluded. Such claims are carefully scrutinized. The claim that worker based estimate is high is not accepted unless proper books are maintained. For trucks and taxis extent of gas used is determined from the speedometer. Nature of journeys performed, i.e., within the city or between cities is taken into accounts for determining gross receipts.

For dentists the Tadrich analyses each type of service, i.e., fillings, crowns, extraction's, etc. The costs of input as a percentage of fees is determined. Where proportion of costs claimed is higher the figure of turnover is estimated on the basis of correct proportion. In the course of audit figures of a small period, say a month, may be taken at random to support the ratios.

In case of building contractors consumption of items like iron, cement and tiles is used to work out the nature and area of the construction. Values of land and price tables are prepared for quick working of the income.

For trucks the turnover and income are based on consumption of gas. Age of a truck is not considered relevant as 'from economic point of view it does not make any difference'. In case of industry the general approach is to estimate output from the nature of machinery, number of hours worked, electricity consumption to verify extent of use and consumption of raw material.

In areas considered too difficult Tadrich may only spell out areas which should be looked into. This has been done for legal profession. Medical profession is also in this category. No

Tadrich has been attempted. <u>In such cases property information in the return is used</u>.

A form of 'Collective Tadrich' has been attempted in the case of diamond merchants. Normally, there is resistance to book keeping on the ground of nature of trade and complete secrecy practiced. The mis-match between contribution to GDP and the income tax paid was determined, with information collected from the customs department which has import-export data, and highlighted to the trade. It was made clear that no claim of losses will be accepted. This was done at the level of National office. The attempt would be to fix revenue targets for different segments of the trade like those producing diamonds and those simply setting them, etc.

Tadrich has also been prepared for expenses on travel to different foreign destinations. These include travel cost and stay cost.

IV.2.8.3 Compilation: Each Tadrich is prepared by an economist of the economic division. The area of industrial or trade activity is first decided at the level of the National office. The economist then proceeds to get the list of taxpayers in that line from the field offices. Lists are also obtained from trade organizations, telephone directory and also those carrying on business having interaction with the selected industry. For example, for tour operators lists available with guides were also obtained and utilized.

Initially, the economist starts visiting some business at random. No questionnaire is issued and focus is on personal interviews based on well prepared line of questioning, cross checking from books and related information sources and visiting again and again. Law provides the economist with authority to question the persons and see the books. Initially, the focus is on acquiring full knowledge and a feel of the business. It is made clear at the outset that the information obtained will not be made available to the inspector auditing the case of the taxpayer. Once that is understood and accepted people are more readily forthcoming. Often greater insight is obtained by ascertaining the business practices of rivals. The information once collected is cross checked. For instance the claim of production from a machinery is checked through the manufacturer or importer of machinery. Manpower required for running the

machinery or electricity consumption is similarly checked. The business is visited again to match the information with the details shown. A mis-match results in further questioning to determine the possible causes and identify other factors which affected the output or the areas where there is tendency to understate the output and overstate consumption or number of employees. At this stage, the visits become focussed and cease to be random. Each area likely to give information is covered and there is constant checking back and forth.

There is no fixed criteria of the number of businesses to be examined. The visits continue till some definite pattern begins to emerge giving indication of levels of outputs, consumption and profits in relation to easily ascertainable norms. Once all important areas are covered the relatively unimportant areas are left out with some generalizations. The number of businesses visited would depend on complexity of the economic activity. The size of the sample has to be statistically significant to lend legitimacy to the conclusions. Tax records are not seen as a part of this process and the economist never puts any questions relating to declaration of income. The information collected is not available to any inspector. Only the final Tadrich is made available to all the inspectors.

The time taken normally varies between 3 to 4 months for simple activities like hairdressing shops and 9 to 12 months for activities which are complicated from economic point of view.

IV.2.8.4 Application of Tadrich: The actual application of Tadrich is through proper training of the inspectors on how to use it. There is no area where the law or practice provides income determination only through Tadrich. Tadrich enables an inspector to pin-point areas of serious 'gaps' once the case is taken up for audit. Gaps with marginal revenue impact may be ignored. The visit to business premises is then for specific enquires and no other area is examined. If the inspector is satisfied that gap is due to specific and justified reasons the lower income is accepted. In other cases income estimate keeping in view the Tadrich and specific data relating to the taxpayer is conveyed. Most of the cases get settled by consensus. In case of disagreement the case will go to the court. However, the National office is informed in advance.

Also small tinkering is discouraged. Cases where estimates from Tadrich are grossly above the declarations do not result in such estimate being straight away adopted. The approach is to get a gradually higher level of declaration. The two specific instances cited relate to income from taxis where levels of disclosure are estimated to have increased from 30 to 35 per cent earlier to 80 to 85 per cent after Tadrich was introduced. Similarly, in case of diamond merchants huge losses were being claimed earlier. This has stopped after the National office intervened.

Tadrich is available to the inspector through the computer. Every time a case is taken up for tax audit the National office is informed. All orders are signed by the head of the Link and the concerned inspector.

IV.2.8.5 **Summary:** *The system of Tadrich as described above is:*

1. A scientific and comprehensive exercise covering different areas of economic activity essentially as an aid to improve the knowledge and efficiency of tax inspectors.

2. Its application is not a must for any category of taxpayers.

3. It is taken into account only when a case is taken up for audit. There is no upper income or turnover level restricting its application.

4. It does not take away the discretion of the inspectors. The discretion does get restricted as the income determination has to be with reference to it.

5. Tadrich has never been used either for identifying potential taxpayers or for increasing the number of taxpayers. This, the officers feel can be done only through field visits by tax inspectors.

6. It is not used in the process of selection of cases for audit. For this comprehensive data is screened in the National office. Selection at the local level is on the basis of personal knowledge of the inspector.

7. The right to take up a case for audit cannot be questioned on the ground that returned income is more than that indicated by the Tadrich. Cases can be picked up on the basis of history. Thus, those earning higher income cannot benefit from Tadrich.

8. The studies can be prepared at any pace depending on available manpower. An independent economic division has to be created at the national level to undertake the task. The officers will have to be given authority to scrutinize the record and record statements.

9. Where difference is substantial the overall approach is not to ensure declarations of the level worked out in Tadrich but to get a gradually increasing level of declarations approaching the level of Tadrich.

10. In preparing Tadrich tax records are not seen and information is collected only through surveys and interviews.

11. Tadrich has no immediate application for identifying new taxpayers. However, once sufficient number of such studies are prepared and the tax officers gain experience on their application, it may be possible to use these for identifying potential taxpayers by identifying norms below which income earners could not earn taxable income.

12. The system does not discourage book keeping. In fact, book keeping requirements are prescribed in detail and their implementation ensured through a separate unit. Non maintenance of prescribed books results in penalties and other consequences.

1. The system as described is based on the discussions with the Officers of the Fiscal Legislation Department of the Finance Ministry, Government of France. Though every attempt has been made to present the position accurately, the author takes full responsibility for inaccuracies, if any, and would be grateful to those who may bring it to his notice.

2. No documents could be obtained in regard to working of these centres in the course of discussions. A request for the same has been made.

3. The system as described is based on the discussions with the Officials of the Research and Planning Administration, Government of Israel. Though every attempt has been made to present the position accurately the author takes full responsibility for inaccuracies, if any, and would be grateful to those who may bring it to his notice.

4. One US $ is equivalent to about 3 NIS (Shekels).

CHAPTER V

CONCLUSIONS AND RECOMMENDATIONS

The narrow base of direct taxation in India is highlighted by the fact that there were a mere 8.95 million processed income-tax returns in 1993-94 (including returns pertaining to past years), in a country with a total population of over 900 million people. Of these returns less than 0.2 million were from corporate entities. The number of taxpayers declaring incomes above Rs. 5 lakh, aggregating across companies and all other income taxpayers, numbered 74,000, and those declaring incomes above Rs. 10 lakh were a mere 37,000. It is in this context that there is a need to use all available mechanisms for enlarging the income tax base.

An increase in the number of filed returns alone would achieve no revenue additionality whatsoever within the limits posed by the conventional reliance on income actuals as declared by the taxpayer, in the face of the critical absence of an information base with which self-declaration can be independently verified. Indeed, where a taxpayer reports income below the taxable limit, and there is no legally acceptable basis on which this can be questioned, it is better if the taxpayer does not file at all so that scarce administrative resources are not expended in revenue-unproductive processing.

Of the two ways by which other developing countries have sought to achieve base-broadening within the same constraints, final withholding is not examined this report, which focuses exclusively on experiments with the use of presumption. However it should be noted in passing that final withholding has a number of virtues, not the least of which is taxpayer convenience and reduction in the number of filed tax returns. Thus final withholding is a useful complement to the introduction of presumption, as a way by which to release the manpower that will be required for processing sectors and occupations currently outside the tax net. This makes schedular and presumptive approaches not mutually exclusive

alternatives, but **complementary ways by which to achieve base-broadening**. Final withholding is admittedly less equitable than progressive taxation of globally aggregated income. However, it is decidedly more equitable than a system where global aggregation is difficult to achieve, and should emphatically not be viewed as an admission of failure by the tax administration.

It has long been a commonplace to recommend presumption for the informal sector in developing countries. Collectively termed the hard-to-tax, these are the small retailers and service providers like barbers, for example, who do not keep formal accounts; those like transporters, builders and contractors of various types, who are engaged in activities involving large numbers of petty cash transactions; those engaged in sale of liquor, who generally obtain contracts in the names of fictitious persons or persons with no means; and professionals like lawyers and doctors who do not maintain proper books of accounts although perfectly capable of doing so.

These sectors, while considered the rightful preserve of presumption, are at the same time often dismissed as revenue-unfruitful, on the basis of presumptive experiments that have either been ill-designed, with unindexed absolute levies, or ill-conceived, with presumptive norms based on no surveys or other objective criteria. It is difficult to provide any quantification of the potential revenue fruitfulness of well-designed schemes based on objectively derived presumptive norms for these sectors, although some estimates for the legal and medical professions are given in Appendix I. It is important to remember the Israeli experience of revenue decline after the mid-70s removal of tahshivim, which was the reason for their reintroduction in the form of tadrihim.

The Indian experiments with the hard-to-tax once again have suffered from design defects. The presumptive final withholding on liquor and forest product contractors suffered legally from the lack of any basis for the presumptive norms specified, and from a complete lack of regional or other stratification. This serves as a warning that presumptive norms must at all times be framed in a manner acceptable to appellate authorities.

In addition to the sectors conventionally classified as hard-to-tax, there are in India large enterprises in trades like jewellery and garment manufacturing, which escape the tax net because of the total lack of objective bases on which to verify expense claims. Here, the issue is not one of whether the basic accountancy skills exist in these sectors. It is very simply one of the need for presumptive norms as a basis upon which to check fraud in book-keeping.

Although agriculture is one of the hard-to-tax sectors for which presumption is conventionally recommended and frequently practised, no detailed recommendations are presented here since fiscal authority for taxation of agriculture rests in India with the States. This source of income is to be particularly commended for use by panchayats under the new scheme for fiscal devolution after the 73rd Amendment to the Indian Constitution, with enforcement and compliance likely to be highest if revenues raised from a presumptive tax on agriculture are earmarked for agricultural infrastructure. Taxation of agricultural income at whatever level of government will have the additional advantage of making enforcement of taxation of non-agriculture income more efficient, because non-agricultural income can now no longer be fraudulently assigned to an agricultural source.

What has moved presumption to centre stage in recent years is its possible use with respect to large corporate taxpayers who are not among the traditional hard-to-tax. In any tax system, there is a small group of taxpayers who together make the largest revenue contribution, aggregating across direct, indirect and withheld levies. It is now an accepted dictum that concentration of enforcement efforts on these large taxpayers yields the highest incremental reward to effort.

Some of the largest corporate giants in India today pay no income tax whatever. This is a result of both use of tax concessions to reduce taxable income as well as underreporting. India has had the experience of a minimum tax on corporations which was introduced with Section 115J of the Finance Act of 1988, and deleted after a brief life by the Finance Act of 1990. Although not presumptive in design, the intent of computing minimum taxable income at 30% of book profits was to combat base erosion through avoidance. Its discontinuance was formally stated to be the withdrawal of tax-reducing concessions, but the phenomenon of

zero-tax companies continues to this day, and among some of the largest profit-making corporate giants. It is important to remember that there was no court judgement that was adverse to section 115J, despite some wrangling over the carry forward of loss and depreciation.

It is recommended here that instead of reactivating Section 115J, an asset-based minimum alternative tax (MAT), which places a floor on corporate tax payable can effectively combat both corporate tax deferment and evasion. This is clear from the wave of MATs introduced in the developing world, with considerable revenue success. Although the tax loopholes which make possible corporate tax avoidance can be eliminated directly, it is easier to outflank the relevant interest groups than to attempt a direct attack. Again, it is far easier to place a floor on tax evasion through practices such as transfer pricing by multi-nationals than to mount a direct attack through construction of arm's length prices.

Assets are the usual but not the only possible base upon which to rest presumption of corporate taxability. French corporate presumption, and by extension that in Francophone Africa, is turnover-based. A turnover base, however, when applied at a flat rate across all sectors of industry, lacks the economic justification that an asset base has. The rate of return to capital, adjusted for differences in risk, would in principle be equated across sectors by capital flows, unless impeded by entry barriers. By contrast, it is impossible to prescribe a uniform share of taxable income in total turnover across all sectors. Turnover is also easily concealed.

In what follows numbered recommendations for presumptive taxation of corporate enterprises will be presented, where the principal objective is to combat base erosion through exploitation of tax concessions. This will be followed by recommendations for other sectors which may collectively be termed informal, but are not for that reason to be thought of as consisting exclusively of small enterprises, where there is a high incidence of non-filing and under-reporting in an information vacuum which makes verification all-nigh impossible.

Recommendations for Corporate Enterprises

1. A minimum alternative tax (MAT) can and should be introduced in India without any delay, to combat underpayment of corporate taxes, whether on account of tax loopholes or evasion. The initial spadework is minimal.

2. A MAT is levied in parallel with the conventional corporate income tax with a crediting provision, and is superior to a minimum add-on without a crediting provision. The incremental tax under a MAT on income actuals is zero until the minimum presumed rate of return is reached, whereas with an add-on the incremental tax is not zero over any income range. Thus, although an add-on requires less spade-work than a MAT, it does not carry the efficiency incentive of a MAT. The greater the performance shortfall below the minimum presumed under a MAT, the greater is the excess of the implicit tax rate on income actuals over the prevailing corporate tax rate.

3. Under the present international tax regime, multinationals cannot obtain credit in the home country for income taxed presumptively in the host country. As long as this regime continues, the design of a MAT should call for the conventional corporate tax to be paid in full, with offset against the presumptive tax floor rather than the other way around. **Thus, the MAT itself becomes payable only when the minimum tax exceeds actual corporate income tax payable.**

4. The first task is to prescribe a minimum rate of return on assets, which is near enough to the average pre-tax rate of corporate return to serve as an adequate efficiency incentive but which is not at the same time punitive. The Peruvian presumed rate of return of around 6.7% on a total asset base is the highest of those presently in force. Most fall in the 3-5% range, and there is no marked relationship with whether the base is net worth or total assets.

5. A total asset base is preferable to net worth because it does not introduce a bias in favour of debt over equity finance, and eliminates the problem of having to detect

fraudulent debt. Total assets can be taken at their written down value in accordance with the provisions of the Companies Act, at historical cost. Revaluation of assets is done by very few companies, and usually extends only to land and buildings.

6. A minimum presumed rate of return of 5% on total assets, at the present base corporate tax rate of 40% excluding surcharge, would imply a 2% rate of levy on total assets.

7. An asset-based MAT is not recommended for the financial sector. It should however extend to leasing companies. This will close a loophole for an asset-based tax on other companies, and also have the side-effect of enforcing uniformity of reporting among leasing companies.

8. Closely linked to the minimum presumed rate of return is the issue of whether or not to provide for offset against MAT payable in years other than the current year. The Mexican variant provides that any excess of actual income tax over the minimum can be carried back ten years against past excess of minimum over actuals, and a refund obtained. A provision of this sort serves four functions:

   (i) It provides legal protection against the charge that the levy is unrelated to ability to pay. With a carryback period as liberal as the Mexican, the MAT essentially becomes a minimum payments provision.

   (ii) It mitigates the severity of the levy, although perhaps a carryforward provision for credit against future MAT payments would grant relief in years of poor performance, unlike the Mexican design which provides a refund in years of good performance.

   (iii) In either form the provision should serve its most important function, of providing an incentive for the accurate reporting of returns even in years where actuals exceed the minimum threshold.

(iv) As a minimum payments provision, there is every justification for keeping the levy simple, with very few qualification or concessions. A levy introduced to combat corporate tax complexity must itself remain simple to be effective.

9. Under the design dictated by the present international tax regime, the revenue impact of the MAT is through the buoyancy it imparts to collections under the conventional corporate tax, resulting from the efficiency and accurate reporting incentives, rather than in terms of direct collections under the MAT head. It is important to stress this, because the low share of MAT collections in the total can easily be parleyed into an argument for deleting it.

Recommendations for the Non-Corporate Sector

1. Enlarging the scope of presumptive/estimated income taxation will broaden the tax base and strengthen the verification and monitoring capabilities of the tax administration.

2. An asset-based tax whether as a substitute or as a minimum tax is not recommended for the non-corporate sector because of the widespread prevalence of benami holdings, which would make proper implementation almost impossible.

3. Presumptive norms for income determination from easily observable entity-specific indicators must first be established. The procedural requirements for this are detailed further below.

4. Once the norms are specified, a straightforward application of income determination based on these, except where prescribed books of accounts are not maintained, is bound to face strong legal challenge as in the case of the now deleted Section 44AC. The existing practice in France and Israel for using these norms as a benchmark in selection of cases for scrutiny and in the process of scrutiny is, therefore, recommended where books of accounts are maintained.

5. The norms as established should be used for all enterprises engaged in that economic activity irrespective of the income level or whether it is a new or old enterprise.

6. The use of norms as a benchmark would not exclude assessments on the basis of history of the case. Thus those earning higher incomes would not be able to take advantage of the norms and declare lower incomes. Once reasonable norms have been devised it can be expected, in course of time, that all taxpayer will prefer to ensure that their declarations are in conformity with the norms.

7. After gaining experience with application of the norms an attempt could be made to identify a smaller sub-set of indicators on the basis of which it could be prima facie concluded whether the income exceeds the taxable threshold or not. Information regarding such a sub-set of indicators collected from non-filers through surveys could then be used for identifying potential taxpayers.

8. The use of norms must be backed by detailed formulation of book-keeping requirements for taxpayers involved in different economic activities in accordance with their income levels and competence. Thus while such requirements may be simple and may require maintenance of only cash books recording daily receipts and expenses at the lowest level, these should be gradually more meticulous with strict book-keeping requirements for businesses above a certain size on the basis of income and assets.

9. The book-keeping requirements after being simplified, keeping in view the practical problems of the income earners and the aim of income estimation through presumption, must be strictly enforced. Enforcement could be through extensive surveys, limited in scope of signing of books without any attempt at income determination, by separate units not involved with assessment tasks. Stringent penalties should be provided for those failing to maintain books even after the requirements are simplified. These may be monetary or forced closure of business for a few days.

10. Efforts should be made over time to ensure that all those engaged in economic activity, irrespective of income level, should be registered with the Income Tax Department (taking care to explicitly exclude certain occupations - ambulatory vendors, street service providers - from this requirement). Stop-filers must be screened for some years to verify that income is below the taxable threshold.

11. Computerisation is an absolute pre-requisite for the maintenance of occupation-specific listings. The process of development of presumptive norms could however be commenced immediately in tandem with the on-going project of computerisation.

12. Specification of occupation-specific norms requires sustained and systematic survey effort. These surveys should be conducted by persons not involved with assessing the enterprises being surveyed. Any attempt to short-cut this process and devise norms through the assessing officers on the basis of income tax records will create problems (see Appendix II). The essential features of this exercise would be as follows:

    a. <u>Set-up</u>: A research group should be set up at the Centre with Units in each Chief Commissioner's Office. The members of the group should be mostly economists and statisticians working under experienced officers of the level of Deputy Commissioner of Income Tax or Commissioner of Income Tax, preferably with an economics background. The officers of the group should have powers of survey and summons as vested with the Assistant Director of Inspection.

    b. <u>Selection of activity</u>: This should be left to the discretion of the Chief Commissioners. Preference would have to be given to activities where there is clear concentration of income or wealth disproportionate to payment of taxes and where reliable sources of information are available for developing the norms.

c. <u>Modality</u>:

i. The first task after initial selection would be to list persons engaged in that economic activity. For this purpose, registration lists with State and local authorities, membership lists of trade and professional organisations, telephone directories, surveys conducted by National Sample Survey Organisation and the decennial Population Census data would be used. The field units will have to have proper staff and infrastructural support for completing this task.

ii. Once a listing for the selected activity has been completed, a sampling frame is available from which to select a sample for a detailed field survey. Technical assistance in matters of sample selection should be sought from the National Sample Survey Organisation.

iii. Prior to the field survey there should be no pre-judgement of which indicator/s, and by extension which form of presumption, whether estimation of actual income or capacity-based potential income, would be most suitable for the activity in question. The survey should collect information on all inputs, both fixed as well as variable inputs by type and quantity, as well as on the type and quantity of outputs. The appropriate indicator can only emerge after all possible indicators are examined for stability in relation to taxable income. The selection of indicator/s has to keep in mind, in addition, practical considerations such as ease of observation, concealability and substitutability.

iv. In addition to field surveys, information may be collected through discussions with selected individual practitioners, study of income tax records and discussion with trade organisations. This will also enhance acceptability of the norms by the taxpayers and appellate authorities.

v. It is vital, for the preservation of intra-occupational equity, that the norms be stratified by important occupation-specific parameters that make for differences in taxable income. There will be no need for regional stratification, since the norms will be developed in a region-specific manner in the first instance.

vi. Existing information bases on usage of inputs like water and electricity should be used, in the process of identifying suitable indicators, as these are readily available at little incremental cost.

vii. Because the Israeli authorities have experience ranging over more than forty years of developing occupation-specific norms, it may be useful to arrange visits to the field units by some of their English-speaking staff.

d. Content: As already emphasised the focus should be on identifying indicators which are easily observable and not easily prone to concealment or substitution. The surveys should also establish the source of major inputs and ultimate destinations of the outputs of each activity so as to provide a basis for further investigation of related upstream and downstream activities and also for cross checking information given by those engaged in the economic activity.

Where norms cannot be established, the studies should identify areas of possible fraud to be looked into by the assessing officers in cases picked up for scrutiny. The Study should also, in that event, bring out specific cases in that economic activity where concealment has been detected.

e. Role of Central unit: The Central unit should undertake studies on its own for those economic activities where inter-regional disparity is minimal, for example banking, finance and leasing companies, transporters etc. In addition, it should ensure that selection of economic activities focuses on areas with

substantial revenue potential and that there is proper harmony between norms developed in relation to the same activity in different regions.

f. Implementation: Proper implementation of norms is crucially dependent on proper briefings to the Assessing Officers through special Workshops. Thus every study must be followed by appropriate training before implementation. Economic activities where there is vast difference between incomes as indicated by the norms and as declared should be brought to the notice of the Central unit by all the field units for development of appropriate strategies.

The Income-tax Act will have to be amended to authorise the CCIT to call for additional information relating to the selected indicators for any economic activity, alongwith the Income-tax Return.

13. The revenue impact of the above recommendations is bound to be substantial in the long run when a sufficient number of activities have been surveyed and the returns of the taxpayers have been subjected to scrutiny on the basis of the resulting norms. Other beneficial outcomes will be increased efficiency of administration and a restriction in the area of discretion of assessing officers with consequent reduction of taxpayer harassment.

14. Implementation of the recommendations should commence immediately. The number of studies would be limited to what is possible with the available manpower. Once adequate manpower is provided and the tax administration is sufficiently computerised, a large number of economic activities could be covered by the studies.

15. The present levy of Rs 1400 for taxpayers with turnover upto Rs 5 lakhs and income upto Rs 47,000 from prescribed economic activities has been a good start. It needs to be fortified with listings of potential taxpayers under the scheme, or at least some estimates of their number. Similarly there is no rationale for confining the scheme to specified economic activities. By excluding the existing taxpayers from the scheme inequity is created against those who were complying with tax laws. These

restrictions therefore need to be removed. Once occupation-specific norms are devised, the income of taxpayers who do not maintain any books of accounts should be estimated on the basis of the norms. The scheme will, therefore, have to be modified appropriately at a later stage.

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APPENDIX I

TAX EVASION IN THE SERVICES SECTOR

The Central Statistical Organisation conducts periodic surveys on the service sector as a part of the national accounts estimation exercise. These are the only available source on a nationwide basis of information on value added and incomes in services. The 1983-84 survey, for the revised series on national accounts with base 1980-81, is the latest for which published results are available (CSO, 1987). A more recent survey was conducted in 1991-92, for which published results are not available.

Table A.I.1 presents the 1983-84 survey figures separately for enterprises with and without hired workers of average gross income per enterprise, per operating partner, and per hired worker, for five service groups at NIC two-digit level (information at further levels of disaggregation is not available, and net income figures are not provided for enterprises not hiring workers). The figures fail the plausibility test. The average annual gross income per enterprise with hired workers in recreation-providing services which includes motion picture production (NIC code 95), of Rs. 21330 in 1983-84, is quite simply ridiculous. Likewise the figure of Rs. 9690 per private medical enterprise with hired workers is not even remotely credible.

Comparable nationwide averages are not available from any other source. However, some region-specific surveys may give some idea of the magnitude of underestimation in the CSO figures. A survey of incomes earned by non-government medical practitioners in 1990-91 in the Delhi region (Kansal, 1992), reveals that those practising in clinics earned 20 times the urban average from the CSO survey (averaged across all enterprises, including those not hiring workers), updated to 90-91 prices. The corresponding factor for those running nursing homes was more than 50. The two surveys are of course not directly comparable on several counts; the Kansal survey was confined to Delhi and covered just allopathic practitioners, where the CSO survey covered all practitioners of medicine including those using indigenous systems, and was a nationwide average (but both surveys are confined to private practitioners). Even so, the comparison gives some indication of the magnitude of underestimation involved.

A ranking of occupations by income is possible from the CSO survey nevertheless. Of the five occupation groups, the legal profession is at the top of the rankings for both income per enterprise, and income per hired worker. The absolute annual income of legal enterprises with hired workers, even at the appalling degree of underestimation of the survey, was well above the taxable threshold of Rs. 15000 in 1983-84, but it must be remembered that the figures in table A.I.1 are of gross income.

TABLE A.I.1

Income of Commercial Enterprises in the Service Sector 1983-84

NIC Code	Services	Number Sample Enter-prises	Estimated Number of Enter-prises	Average Workers Per Enterprises		Gross Average Income (Rs. 10^3)		Average Wage Per Hired Worker (Rs. 10^3)
				Owners/ Partners	Hired	Per Enter-prise	Per Partner	
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
96	Personal: laundries; barbershops; photographers; etc.	7980	818264	1.54	-	3.29	2.14	-
		935	76865	1.24	1.66	7.50	6.05	3.28
95	Recreation: including motion picture production; distribution and projection; theatrical and cultural services	566	52301	2.11	-	2.83	1.34	-
		320	36045	1.59	7.14	21.33	13.42	2.35
93	Medical (non-governmental, excluding veterinary)	2010	206602	1.06	-	6.05	5.71	-
		1272	122848	1.09	2.84	9.69	8.89	3.19
83	Legal	868	67268	1.02	-	9.07	8.89	-
		306	39571	1.13	2.56	32.62	28.87	9.21
82	Business and real estate	1474	123999	1.27	-	4.04	3.18	-
		592	44395	1.28	2.24	13.66	10.67	4.31

Source: Government of India, Ministry of Planning, Central Statistical Organisation (1987), Department of Statistics, **Enterprise Survey, 1983-84: Report on Service Sector**, Statements 3.1.3, 3.3.3 and 3.5.3, New Delhi.

Notes:

1. For each occupation, the first row of figures is for "own account enterprises (OAE)" not hiring any workers; the second for enterprises hiring one or more workers. The samples were independently selected, and a separate canvassed, for each of these two strata.

2. Gross rather than net income per enterprise is given here because figures for neither depreciation nor assets are available in the source publication for OAEs and non-OAE medical enterprises. Although, the definition of operating surplus is given as total receipts minus total expenditures defined to include additions to fixed assets, the figures suggest that in practice this was not done, and that only recurring expenditures were (correctly) subtracted.

Table A.I.2 provides estimated net income of enterprises with hired workers, by rural/urban breakdown, from which it can be seen that the disparity between rural and urban net income is not very wide, and that **the average net income of even rural legal practitioners fell above the taxable threshold for the year**. That such a finding should come out of a survey that seriously underestimates incomes is in itself a matter of considerable significance, and suggests at the very least that in terms of priority, legal service enterprises large enough to have at least one hired worker are worthy of consideration for a presumptive levy.

TABLE A.I.2

Average Income and Tax Liability of Legal Enterprises: 1983-84

	No. Hired Workers	Hired Workers		
		Rural	Urban	Total
Number Sample Enterprises	868	6	300	306
Estimated Number Enterprises	67268	635	38936	39571
Partners/Enterprise	1.02	1	1.14	1.13
Hired Workers/Enterprise	0	1	2.59	2.56
Gross Income/Enterprises (Rs. 10^3)	9.07	27.70	32.71	32.63
Net Income/Enterprises (Rs. 10^3)	-	26.61	29.97	29.92
Tax Payable (Rs. 10^3)	-	3.31	4.49	4.47
Tax Rate	-	12.45%	14.98%	14.95%
Total Potential Tax Revenue (Rs. 10^3)	-	2104.39	174803.17	176961.51

Notes: 1. Legal enterprises are defined as those rendering legal services such as by advocates, barristers, solicitors, pleaders, mukhtiars, etc.

2. The only way to obtain net income from the gross figure was by deducting reported depreciation, since fixed assets as recorded in the survey included land, and no break-up of the aggregate is provided in the published figures. Depreciation was recorded in the survey as provided for by the responding enterprise, and may or may not have corresponded to income tax norms (the implicit depreciation percentage of fixed assets was 9.31% for rural enterprises, 8.40% for urban). No depreciation or asset figures were recorded for enterprises not hiring any workers.

3. Tax payable is calculated at the slab rates for individuals prevailing in 1983-84 (at 25% between 15,000 and 20,000, 30% upto 25,000 35% upto 30,000) as applied to enterprise income. Where enterprise income was split by partner, there was in 1983-84 a corresponding levy on the enterprise at the rate for registered firms, an adjustment that cannot be made without data on the distribution of enterprises by number of partners. In any case, the average number of partners per enterprise is not much above one.Table A.I.2

Clearly a serious examination of this issue calls for better figures and more possibilities of stratification than merely by rural/urban location alone. But taking the 1983-84 survey figures as they stand, table A.I.2 presents a primitive calculation of presumptive tax liability. Applying the individual taxation rate schedule of 1983-84 to average net income per enterprise (the average number of partners per enterprise was 1 in rural areas, and 1.14 in urban areas),[1] yields a presumptive levy of Rs. 3314 per rural enterprise, and Rs. 4490 per urban enterprise, at implicit rates of 12.45% and 14.98% respectively. An undifferentiated levy on average income across all enterprises, rural and urban, works out at Rs. 4472, at implicit rates of 16.81% and 14.92% on rural and urban enterprises respectively. This underscores the need for any presumptive levy in practice to include as many parameters of stratification as possible so that systematic factors explanatory of variations in income are taken care of.

Both the differentiated and undifferentiated levies yield a total revenue of roughly 17.7 crores of rupees. This compares with a figure for total tax collections from legal services for assessment year 1984-85 of Rs. 13.5 crores, at an implicit tax rate of 26.52% from 13156 non-company assessees. This figure is from the All-India Income-tax Statistics, which is known to be a variable sample of the returns submitted in any year. The information base for AY 1984-85 was a total of 34.38 lakh non-company assesses above the taxable limit. The report of the Comptroller and Auditor General shows a total of 36.86 lakh non-company assessees above the taxable limit as on 31 March 1985. Applying this correction factor to actual collections from legal services in assessment year 1984-85 **yields a total of 14.5 crores. This compares with the calculated yield from a presumptive levy of Rs. 17.7 crores, yielding a 22% shortfall of actual collections below the potential, which in turn is based on a survey that is known to have hopelessly under-estimated figures of income from service enterprises.** Even if the survey had been accurate, actual collections should have exceeded the yield from a levy based on average income, given the progressive rate schedule.

Any respectable presumptive income scheme will have to be based on a survey as reliable as Kansal's on a nationwide basis. The Kansal survey suggests three distinct strata for medical practitioners: those without surgical post-graduate qualifications; those with surgical post-graduate qualifications; and those operating nursing homes; with there clearly being a fourth stratum of those practising indigenous medicine and therefore not covered in the Kansal survey. There is also a location element in income earned even within the Delhi region. The Kansal survey is merely suggestive of the types of stratification that will be necessary, but cannot prejudge the issue.

1. The justification for why individual rates were applied to enterprise income, even though the number of partners per enterprise was slightly greater than one in urban areas, is that in the event of a sharing of income and separate taxation of partners, the firm itself would have been subject to taxation at the rate for registered firms. An assumption that all firms would have been taxed on this basis would bias upwards the estimate of revenue yield.

APPENDIX II*

ASSESSMENT OF LOTTERY BUSINESS

II.1 Introduction:

In this appendix, a sample of 99 Income Tax returns from the lottery business was examined. The purpose was to see whether any stable parameters relating taxable income to presumptive indicators could be established, from returns and assessment orders, for this activity. The lottery business is among those where the degree of evasion is suspected to be very high.

In what follows, section II.2 deals with some of the significant problems identified by the CAG regarding assessment of those engaged in the lottery business, in its annual reports. Apart from the problems highlighted by the CAG, the other drawbacks which have been prevailing in the sample and have prevented the study from being a comprehensive one, have also been analysed. Section II.3 gives a brief description of the sample of income tax returns which have been used for the analysis. Section II.4 deals with the objections which were raised by the CAG and identified in the sample. In section II.5 the indicators which have emerged from the statistics have been highlighted. Finally, in section II.6 an attempt has been made to arrive at some conclusion although it has been admitted that such conclusions would be based on a lot of assumptions and ambiguities due to the deficiencies in the available data.

The lottery business is conducted by the government sometimes directly and sometimes through private agencies who either pay royalties to the government or work on the basis of commission as sole selling agents.(Comptroller and Auditor General of India, No. 6 of 1990, Revenue Receipts, Direct Taxes.)

II.2 Summary of CAG Objections:

The CAG (no.6 of 1990) identified many drawbacks in the procedures adopted by the department in the assessment of lottery business. They were as follows :

1. Evidence of evasion: That there was widespread evasion in the activity was borne out by :

(a) test checks which disclosed wide disparities in the income returned and assessed. Despite this, very few returns were subjected to scrutiny assessments; while a few were subjected to summary assessments most of the remaining returns were accepted.

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* This appendix was written by Sarmistha Roy.

(b) registered firms and individuals engaged as sole selling agents concealed income accruing from agents commission, stockists bonus and agency/sellers bonus apart from misreporting and suppressing the turnover of tickets leading to an underassessment of income and short levy of tax.

(c) the fact that expenses claimed by the assessees were allowed without any changes and in some cases the expenses incurred were not fully vouched.

2. **Failure of documentation:**

(a) The returns were not generally accompanied by details of income returned and supporting documents like, profit and loss accounts and balance sheets. Accounts were not audited even where turnover exceeded the specified amount (under the provision of the Income tax act, as applicable from the assessment year 1985-86, a person whose turnover exceeds a specific amount has to have his accounts audited by an accountant failing which there is provision for levy of penalty). Yet, neither was any action taken nor any penalty levied on those assessees who failed to furnish audited accounts.

(b) In the case of other permissible deductions, not relating to the business, there were instances when assessees claimed to make investments (like NSCs) on the basis of which the assessing officer issued a certificate for deduction of tax at a lower rate, although the required documents were not filed to confirm the fact.

(c) Exemptions given to individuals on grounds of setting up charitable institutions were often found to be irregular.

(d) When payments were made to stockists and sub- agents by way of service charges and commission, the amount paid should have been vouched as "receipts" (in the return forms) and subjected to deduction. However on a number of occasions this was not followed, leading to an escapement of tax.

3. **Failure to furnish statements of tax deducted at source:** There were many omissions regarding the furnishing of quarterly statements in the prescribed forms to the Income Tax Officer by persons responsible for deduction of tax in which the dates of payment of prize money to winners, dates of tax deducted at source and paid to the government and other such useful information were missing.

In some circles a large number of prize winners did not file tax returns on the plea that the tax had already been deducted at source although the source deduction of tax on winnings from lotteries should have been increased by a surcharge of 5% w.e.f 1.4.1987 which was not followed. A detailed assessment of statement of tax also revealed that in a number of cases there were delays in crediting the amount of tax to the Department's account without a corresponding

levy of interest.

4. **Other irregularities:** The other omissions include cases where:

(a) Agents/sellers liable to tax deduction. for being entitled to a percent of the declared prize money on each "prize winning ticket sold", (income accruing from such sources was termed as "winnings from lotteries"), apart from receiving the sales commission and other incentives, did not pay the requisite amount of tax.

(b) Assessees delayed in depositing tax for which no interest was levied by the department which led to an undercharge of revenue.

(c) A prize given partly in kind and the tax deducted should have been with reference to the value of the prize in kind as well as cash; however the particulars of the prize in kind was not included in the statement of tax, leading to an erroneous result.

(d) An individual who won a prize against a ticket, claimed deduction with the declaration that it was held jointly with other members of his family, which was accepted by the assessing officer. The audit scrutiny however revealed that the affidavit claiming the formation of the syndicate was filed after the declaration of the result, which was erroneous.

II.3 Sample of Income Tax Returns:

This is a sample of 99 income tax returns submitted by the Department for examination. The returns pertain to five centres : two from Madras, two from Delhi, and one from Kanpur. There is no indication as to whether the returns are based on any methods of sampling; hence these cannot be accepted as true representatives of all assessees engaged in lottery business, for the country as a whole. The information contained in the returns were confidential in nature; therefore no assessee-specific data have been revealed.

The sample was across various types of assessees engaged in the lottery business who were categorised by the department as : organisers (9) who were the highest in the order and who took major decisions regarding the size of the lottery, the value of prizes etc, followed subsequently by dealers (6), agents (28) and stockists (36) who worked on "guaranteed profit" basis or on "commission" basis. However the categorisation did not reflect a uniform pattern for all the five centres. Above all they did not match the details in the profit and loss accounts. For example, the "stockists" are supposed to work only on the basis of commission, but the some of the returns of the stockists showed that their turnovers were derived from mixed income, i.e. income from "commission" as well as "sale of tickets". Therefore these categorisations could not be treated as water tight divisions.

Income tax returns were generally accompanied by expense vouchers, trading and profit and loss accounts, balance sheets etc., from which some information could be obtained, on the basis of which we could arrive at conclusions. However, as mentioned above, these conclusions cannot be treated as applicable to all assessees engaged in the lottery business since we do not have any information regarding the methods according to which the sample was conducted and whether the sample truly reflects the total population.

Categories of assessees framed by the department	Total number of returns	Number of Returns				
		Showing total declared income	Showing lottery derived income	Subjected to scrutiny assessments	Accompanied by P&L A/c showing	
					Income	Turnover
Organisers	9	9	9	5	8	8
Dealers	6	6	5	3	6	6
Stockists	36	35	26	23	33	34
Agents	20	20	20	4	5	5
Not known	20	20	20	4	5	5
Total	99	97	82	42	70	73

II.4 Objections raised by CAG which were Identified in the sample of income Tax Returns:

Many of the above mentioned problems were identified in the sample selected for the study. They were as follows :

(a) **Failure to carry out scrutiny assessments effectively:** The CAG observation no.1(a) regarding the ineffective test checks carried out by the department despite widespread evasion prevailing in this business, was borne out in this study. Although adequate scrutiny was carried out for the sample as a whole, (the fact that out of a total of 99 returns, 42 returns were subjected to scrutiny assessments goes to prove this point) however, no scrutiny assessments were carried to verify the accuracy of claims of 'business loss' despite the fact that a substantial number of cases reported 'business loss'. This is substantiated by the fact that, out of the 7 returns showing 'business loss', only 4 were subjected to scrutiny assessments and of these only one return showed a substantial revision in assessment while for the others, the 'business loss' was more or less accepted after scrutiny. This indicates that the scrutiny was not carried out in an effective manner.

(b) **Failure to submit accounting papers along with return:** The CAG objection no.2(a) has been observed in a number of returns within the sample, where many assessees had failed to include the 'accounting papers' such as profit and loss accounts, balance sheets etc along with the returns, which complicated the analysis. Out of a total of 99 returns, profit and loss accounts were available for 73 returns, some of which contained inadequate information leading to an underestimation of results.

II.5 Descriptive Statistics:

The information pertaining to the assessees was organised into tables and various indicators which have emerged from them, despite the numerous loopholes, have been enumerated. The anomalies prevailing in the data base have also been highlighted.

However, as pointed out earlier, the data set was incomplete i.e., some information or the other was missing. For example either the "opening balance" or the "closing balance" were missing for many returns. Regarding "unsold stock", it was not clearly mentioned the part which was "dead" and the part which could be reused and hence could be treated as an inventory. The same went for stock at "Retail Counter". Hence, in computing the various indicators, the number of returns often fall below the total number (99) in the sample.

The computations were conducted in 2 different ways:

(1) for all assesses;
(2) for assessees categorised on the basis of turnover

(The breakups were categorised on the basis of turnovers instead of the criteria maintained by the Department mainly because the latter did not show a uniform pattern).

Henceforth, the turnovers based on "Sales income only" will be termed as S, the turnovers based on "Mixed income" (i.e. Sale and Commission) will be termed as M and the turnovers based on "Commission income only" will be termed as C.

(i) **Total declared income:** Out of the total of 99 returns in the sample 97 returns contained information about "total declared income". The average total declared income was approximately Rs.19 lakh.

The breakups by the categories showed the average income to be the highest for M (approximately Rs.44 lakh), which was higher than the sample average and very small for S and C. However the total declared income by itself does not give a very meaningful picture as it contains information about the other sources of income of the assessee (apart from the income accrued from lottery business).

Average Income

Average income details/ number of returns in each category	Type of turnover of income tax returns				
	All (99)	Sales (28)	Mixed (31)	Commission (14)	Unspecified (26)
Total declared	1878760.28 (97)	953401.30 (27)	4425159.90 (31)	283724.14 (14)	613832.68 (25)
Lottery Derived	2116036.21 (82)	1614336.67 (18)	4764403.97 (29)	319482.92 (12)	106756.48 (23)
Scrutiny cases	(41)	(11)	(18)	(5)	(7)
Total declared	3045248.05	927542.82	5458200.00	733700.80	1819442.14
Scrutiny assessments	3693445.95	1497725.36	5940021.28	1076711.20	3236052.29
Scrutiny assessments - total declared:					
(Highest figure)	5189715.00	4016561.00	3202796.00	1390790.00	5189715.00
(Lowest figure)	0.00	0.00	0.00	2660.00	14140.00
(Average)	648197.90	570182.55	481821.28	343010.40	1416610.14
Scrutiny assessments - total declared / total declared (%)	21.29	59.81	8.83	46.75	77.86

(ii) **Lottery derived income:** Out of a total of 99 returns, 82 returns declared positive income derived from lottery business with an average of approximately Rs. 21 lakh (all categories). There were, in addition, 7 cases in which loss was reported, the loss ranging from Rs.89 thousand to Rs.52 lakh approximately. The average lottery derived income was the highest for M (Rs.47 lakh), followed by S and C.

(iii) **Scrutiny assessment:** The degree of evasion was derived from the average difference between the income declared and assessed after scrutiny (i.e. Scrutiny Assessment-Total Declaration/Total Declaration). It is however subjected to limitations because the income assessed by scrutiny is not the finally assessed income. Sometimes scrutiny assessments are contested in the form of appeals and revised; therefore the income assessed after scrutiny should not be accepted as final. However, in view of the fact that finally assessed income details were not available, the degree of evasion was measured from the

available data and was estimated to be 21.29% across all categories. The ratio was very high, of the order of 60%, for S compared to the other two categories indicating that the evasion was of a very high magnitude for the assessees reporting turnovers derived from "Sale" only. On the other hand the ratio was very low for M (9% approximately).

(iv) **Additional tax imposed as a result of scrutiny:** The average difference between the tax paid by the assessees and that imposed on account of scrutiny assessment was 38.06% across all categories. The average was much lower for M compared to the other categories and the highest for C indicating that although the rate of evasion was highest for S (as seen in the earlier case) the difference of taxes was greater for C.

(v) **Income (P & L account) to Turnover ratio:** Out of the total 99 returns, only 70 returns contained information regarding turnover and 67 contained information regarding the income (actually accruing from the lottery business) which was reported in the profit and loss accounts. The break-ups by categories framed by the department showed, that returns from "agents" and "not known" were mostly those that did not contain the information regarding the turnover of the business.

On the whole, the average income (as determined from the profit and loss accounts) to turnover ratio was very small (3.15 for all categories). A comparison of the average ratios at the disaggregated level showed that C had the highest ratio (11.67%), which was much higher than the sample average, while S and M had a smaller ratio. This implied that returns with turnover derived from Commission income (C) were inclined to make a greater profit compared to the other categories, irrespective of the of the fact that their turnover was very small which was expected since this category of assessees were operating on the basis of commission with a higher profit margin. On the other hand, the incidence of profit for M was much lesser, although the average turnover was much higher for this category.

(vi) **Total expenditure vs. turnover:** The expenditures incurred by the assessees, as quoted in their trading and profit and loss accounts, were tabulated under the different heads and the share of the major expenditures in the total turnover were computed for all the assessees and for the different break-ups according to the type of turnover. The dispersion of the share of expenditures was also computed for the sample as a whole and at the disaggregated level.

The total expenditure to turnover ratio was undoubtedly very large for all assessees (91.22%) excepting for those who work only on the basis of commission which was again as expected, in view of the fact that this category was not incurring any expenditure on "purchase of tickets" and "prize money" which were the main components of total expenditure in the other categories. Accordingly, the breakups show the total expenditure to be the highest for S (92.53%) and lowest for C (44.53%).

Average tax and turnover details / number of returns in each category	Type of turnover of income tax returns				
	All (99)	Sales (28)	Mixed (31)	Commission (14)	N.A. (26)
Total tax paid	337747.52 (23)	545412.00 (7)	317154.00 (9)	158137.00 (5)	152619.00 (2)
Assessed by scrutiny	568250.47 (32)	709435.11 (9)	44189.27 (11)	247302.80 (5)	810929.00 (7)
Total tax paid (cases assessed by scrutiny)	337747.52 (23)	545412.00 (7)	317154.00 (9)	158137.00 (5)	152619.00 (2)
Scrutiny tax - tax paid	(23)	(7)	(9)	(5)	(2)
(Highest figure)	3534698.00	785373.00	1254440.00	577323.00	3534698.00
(Lowest figure)	-137983.00	-17481.00	1430.00	-137983.00	8892.00
(Average figure)	335994.26	320879.00	184699.64	89165.80	767323.57
Scrutiny tax - tax paid / total tax paid (%)	38.06	39.00	24.61	56.39	104.59
Income as per P&L account	(67)	(27)	(30)	(10)	
(Highest figure)	50111486.00	6347617.00	50111486.00	877356.00	N.A.
(Lowest figure)	-5235116.00	-5235116.00	-710911.00	-99201.00	N.A.
(Average figure)	2472502.99	681556.33	4815906.70	277847.80	N.A.
Turnover as per P&L account	(67)	(27)	(30)	(10)	
(Highest figure)	2170224937.00	85774154.00	2170224937.00	2832479.00	N.A.
(Lowest figure)	528402.00	1328930.00	528402.00	716162.00	N.A.
(Average figure)	237236604.84	214900593.67	335765716.47	1956500.10	N.A.
Income / Turnover (%)	3.15	2.28	1.08	11.67	N.A.

Sample of income tax returns for assessees categorised according to turnover	Expenditure details								Total expenditure
	Purchase of tickets	Prize money, P.W.T. etc.	Rylt, profits guaranteed	Payments: comm, bonus	Printing, stationary	Transport, cartage etc.	Estab, rent elec, etc.	Advrt, pub sales prom.	
All Returns (70)									
Avg. (% to T.O.)	58.04	56.45	5.28	6.62	3.04	2.03	8.55	2.74	85.66
Std. Dev. (% to T.O.)	45.61	26.31	3.46	10.66	3.92	3.42	17.89	5.20	22.93
Coeff. of var. (%)	78.59	46.61	65.63	161.11	128.89	168.49	209.31	189.93	26.77
Share of exp. (%)	19.39	54.70	3.22	8.59	1.96	0.44	1.56	1.36	91.22
Sales (28)									
Avg. (% to T.O.)	57.54	56.07	6.31	7.03	3.10	1.15	5.69	1.92	93.29
Std. Dev. (% to T.O.)	44.53	29.19	3.26	12.09	2.30	2.83	17.60	2.44	14.58
Coeff. of var. (%)	77.38	52.06	51.68	171.93	74.19	246.57	309.33	126.94	15.62
Share of exp. (%)	30.68	47.25	3.71	3.26	2.39	0.38	3.51	1.35	92.53
Mixed: Sales & Comm. (30)									
Avg. (% to T.O.)	44.75	30.36	2.18	7.27	2.64	0.78	2.14	1.67	91.79
Std. Dev. (% to T.O)	47.47	32.69	3.17	10.70	4.55	0.96	4.50	1.98	12.92
Coeff of var. (%)	106.08	107.69	145.60	147.18	172.36	122.68	209.87	118.56	14.08
Share of exp. (%)	12.55	59.34	2.93	11.85	1.70	0.46	0.34	1.36	90.52
Commission (12)									
Avg. (% to T.O.)	0.00	0.00	0.00	3.78	5.03	7.20	31.24	8.57	52.55
Std. dev. (% to T.O.)	0.00	0.00	0.00	4.36	4.70	3.82	21.40	11.10	28.78
Coeff. of var. (%)	0.00	0.00	0.00	115.38	93.60	53.13	68.51	129.58	54.76
Share of exp. (%)	0.00	0.00	0.03	4.77	4.97	6.81	23.06	5.12	44.76

(vii) **Major expenditures incurred by assessees:** All the expenses incurred by the assessees have been classified under 8 major heads according to the nature of expense. The heads are as follows : Purchase of tickets, Prize money, Royalties, Payments to stockists and agents, Printing of tickets, Transport, Establishment , Advertisement and sales promotion.

A comparison of the dispersion of the share of expenditures to turnover showed that overall dispersion was very high for all the categories (ranging from 50% to 310%). At the disaggregated level the comparison showed some expected results : the highest dispersion was evident for M and the lowest for C; within each group a general trend prevailing was that the highest dispersion was observed for items accounting for the lowest share of expenditures and vice a versa. This implied that the highest dispersion for S and M was evident for "establishment" expenditures which comprised a very low share (ranging from .34% to 3%) of turnover. In the case of C the highest dispersion was evident for "payment of commission" and "advertisement" expenditures which comprised only 5% respectively, of turnover. On the other hand, the lowest dispersion was observed for items which accounted for the highest share of total expenditures: "prize money" (share ranging from 47% to 60% of turnover) and "purchase of tickets" (share ranging from 13% to 30% of turnover) for S and M and "establishment" for C (accounting for 24% of total turnover which was the highest expenditure compared to other items within this category). The conclusion that we can draw from these comparisons is that lowest dispersion within each category was observed for items incurring fixed costs, while items which involved variable costs had higher dispersion.

II.6 Conclusions Derived from the Study:

Taking into consideration the various drawbacks prevailing in the data set, some rough conclusions could be derived after categorising the returns according to their turnovers. However, as there is no information regarding the procedures adhered to for selection of this sample and whether it truly represents the total population, a point noted earlier, the conclusions cannot be generalised. The conclusions which emerged from this study were :

(1) This appears to be a high income business with the average lottery derived income of Rs.21 lakh. The highest lottery derived income pertained to the category of assessees with "mixed" type of turnovers followed by those of "sale" and "commission" income.

(2) The degree of evasion as measured by the difference of income assessed after scrutiny and that declared by the assessee as a percent of the declared income was very high for the category of assessees with income from "sale" of tickets and lowest for the category with "mixed" income.

(3) The ratio of profit to turnover were very small for all the categories in general (3%) and specifically for the category of assessees with "mixed" type of turnovers (1%).

(4) Very high expenditure to turnover ratio (92% approximately) specially for the categories with turnovers accruing from "sale" income and "mixed" income where the highest expenditure was accounted for by the prize money and the purchase of tickets expenses.

(5) Very high dispersion for average expenditure to turnover ratio between and within the various categories. As expected, the "mixed" income group had the highest dispersion and the "commission" group had the lowest dispersion ; within the groups the highest dispersion was observed for items with lowest share of expenditure in the turnover and vice a versa.

We may conclude that the present data set does not yield stable norms for the lottery business. Even if a larger sample of assessed returns were taken it may not be possible to arrive at any concrete conclusion unless and until the information is complete in all respects. In order to have clarity about the nature of the business and the expenditures incurred for conducting it the data set has to be based on field work so that no ambiguities may arise while analysing the data.

APPENDIX III*

Ministere Du Budget	MISE A JOUR 1883	4 020 049 No.
General Direction of Taxes		80
Delegation		B
For the Region D'Ile-De-France		I
31, avenue de l'Opera - 75002-PARIS 2nd division		T C A

REGIONAL MONOGRAPHY

Profession: Iron work trade

Code A.P.E. : 55-71

The 'Forfait' must take into account the facts or realities of the small enterprises and, in particular, the evolution of margins in the considered activity and the taxes imposed on the enterprise.

The norms are applicable to enterprises on the basis of professional, national or regional monography, elaborated by the administration and communicated to the professional organisations which can present their observations.
(C.G.I. art. 302 ter - 2 bis).

I. **General Information**

II. **Professional Order**

III. **Definition**

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* These translations serve only to give a general idea. Details can be had at Government to Government level.

The present monography concerns the enterprises of metallurgy (metal) - locksmiths (iron work) of building.

It is about enterprises whose activity consists of executing the production work and to put in place the light metallic work of the building.

112. Characteristics of the Profession

Following are the distinguishing features of the various types of work carried out:

Iron work which includes the execution and the laying or repairing of metal gates, balconies, the hand railings, stairs, doors of all types and the articles of iron works of the building;

The wholesale ironwork or assembly of metal pieces which consists of assembling or the mounting or setting of the framework of buildings and several other metallic constructions, individual or personal construction, agricultural shed, light footbridges etc. (It is stressed that it is about the middle/average work not presenting any special difficulty of study or of the execution and whose range between the supports does not exceed 20 m).

The metallic workshop: window, doors, metallic partitions, metallic fasteners and shutters; this branch actually undergone a particular rapid expansion with the development of the aluminium work.

The ironwork which concerns the work of protection, of closing and of decorations made with the means of iron polished by hand, hot or cold, with or without the combination of other metals or alloys.

In actual practice the specialisations are not always clearly marked and the activities of different types can be exercised jointly in same establishment.

113. Not utilised.

114. Nature of work

It analyses itself in three principal/main category of works:

the manufacture of the works in workshop.

the assembling of these works and finally the laying of the industrially made objects (industrial protection railing, metallic closures etc.)

the maintenance work and repairing work.

The trade sales are exceptional.

As a general rule the big and the medium sized enterprises execute the new work so that the small ones are rather specialised in the laying, maintenance or the repairing.

Indeed, the manufacturing on large scale limits the domain of small enterprises of the "ironmongery" also called the metalwork of city, to iron work and to a few small works of ironmongery or of framework. Moreover, while certain simple works often demand only manual ability and very little of equipments, the conception and the manufacturing of important works consist usually of preparatory works, use of the thorough knowledge and of sophisticated machines.

115. Conditions of Work

115.1 Locations: Their nature and their importance change according to the size and the orientation of the activity of the enterprise (ironwork, metallic carpentry workshop or metal ironwork).

The premises of the small enterprises in general consist of a unique workshop for manufacturing and setting up, a storeroom where the basic materials are stored and an office.

115.2 Material: The equipment consists of:

- The small hand tools utilised in workshop during the work of smithy/forge and during the fitting of the parts, or used on site for the operation of laying, as well as oxyacetylene or electric soldering;
- The fixed or portable machine tools; shears, chain saws, drills, file connected to a vice etc;
- The material intended to transport workers as well as the equipment and the works; van with roof-rack or a (small) van or truck with support for example.

115.3 Personnel: The enterprises taxable under the system of 'Forfait' generally have an artisanal character.

The exploiter works alone or with the help of small number of workers which can be of labourers or of specialised or qualified workers.

One will notice that in the small enterprises the joint/companion of exploiters accomplishes the different administrative tasks.

According to the information supplied by the professional organisations the average weekly duration of work is actually 39 hours in the region 'Ile-de-France'.

115.4 Purchasing: The materials used are:

- * Principally laminated steel in bars of round, square or rectangulars of sections (iron called large plates) bars of Iron in T, I, U, in special profile for the ironwork and girder etc.;

- * and equally of aluminium and of light alloys, of plastic materials;

- the moulded pieces for the decoration; the window ledge/sill bars, the door panels etc.

- the linking/connecting elements: bolts rivets, metal screws;

- the ironmongers articles: the tools used for loosening hinges, latches; parts of the hinge of a door which helps it to rotate;

- the materials for soldering and the products of waterproofing and protection etc.

115.5 Works:

a. Execution of works: The execution of work consists of many phases which can be classified as follows:

- Preparatory works: establishment of plans, appreciation of the execution time and the cost price.

- Works of the workshop: to put into size, operations of the small factories, assembly for testing etc.

- site works: laying and protection treatment of the works (application of anti-rust paints).

b. Method of price determination: The price of the works are fixed as a general rule in the frame of the markets either as agreed or as measured.

c. Agreed price on the basis of markets: It defines the clauses/terms of work execution and are accompanied by a descriptive estimate or quotation. The setting/regulated price of the work is fixed globally: this price is firm or revisable.

The work price, except T.V.A., is calculated from the cost price of the necessary materials and the cost of the employed labourer (salary and special charges).

To these payouts the entrepreneur applies an increase coefficient to take into account its overheads and the global inclusive margin.

d. Market of price on the basis of measurement: In this case estimation puts forward estimated price of every part of work and the approximate global price.

The exact price, except T.V.A., is fixed only after the completion of works by applying to quantities after exact measurements of the price per unit as agreed:

* Whether after a series of deducted price as the basis of reference ('Central Series' of the academy of architecture, 'national series' of the French Architects Society etc.).

* Whether by a particular rate/tariff or the price invoice/docket prevalent in the market.

116. Professional Organisation and Representation

"The National Union of the syndicate of the metal work of France', which have their registered office at 10, rue due Debaracadere PARIS (1%, cme) include different regional or departmental association or syndicates whose 'La Chambre Syndicate de la metalaillerie" of the Paris region is situated at the same address.

The entrepreneurs coming/pertaining to the federations or chambers of crafts can adhere to the "syndicate/association of artisans and of small building enterprises" linked to the CAPEB.

For the region Ile-de-France, the administrative organisation of this Confederation rests on a geographical distribution.

- the services are installed 43, rue d' Epluches, 95310 saint - Queen l'Aumone manage the members of the Essone, of Seine-et-Marne, of Val-d'Oise and of yvelines.

- the service installed, 46, avenue d'Ivry, 75013 Paris, regroup the members of Paris, and of departments of the "petite couronne", namely the Hauts-de-Seine, the Seine-Saint-Denis and the Val-de-Marne.

For the region Ile-de-France, the 2 syndicates belonging to this confederation are:

- la "Federation of artisans and of small enterprises of building (FAPEB)" 5, avenue Michelet a BEAUCHAMP (VAl-d'Oise) which regroup the members of Yvelines, l'Essonne et du Val-d'Oise;

- The 'Inter Departmental Chambers Syndicate of Artisans and of small Enterprises of Building', 12, rue Flatters at PARIS 5eme covers the rest of the region of Ile-de-France.

Besides, different national, syndicate organisations, represent the specialised enterprises. One can find:-

- The National Chambers Syndicate of the manufacturers of closures" (metal, wood, plastic) Pev 10, rue du Debarcadere a PARIS (17th).

- The "National Syndicate of Constructors of Window Facades and accessory activities" (SNFA) 9, rue de la Perouse a PARIS (16th).

12. Economic Order

121 and 122 - Not utilised.

123. Evolution of Prices

They experience only a weak progress. Their actual level, excluding tax is the following:

a. Although most often the hourly price other than of repairing and of break-down do not figure on the bill, one must consider that it is situated between 100 and 140 francs.

The minimum level price concerns the works in the workshop or for the long duration on the sites, not requiring a particular technique and which involve only the cost of the labourer/manpower.

These are especially the following elements which explain the deviations indicated:

- Works carried out with the aid of the materials and the machines whose depreciation affect the cost appreciably.

- Works needing important consumption of energy and supplies not charged separately;

- Delicate and complex works demanding a special qualification or training.

b. For the repairing and breakdown works, hourly pay varies from 90 F to 150 F; it can be in addition to pick-up charge which generally correspond to an hour of billing;

c. Single/one-off/meticulous works (opening of doors); They are subject to extreme variability, taking into account particularly the sophistication of the system of closing; we can consider that it is situated in the margin varying between 150 and 500 F, this tariff greatly increases depending on the schedule of work; besides the price is much higher in the case of opening of safes.

d. <u>Supplies</u>: Established from the measures of architects and taking into account the discount habitually consented, the co-efficient applied to the purchase price is between 1.42 and 1.49.

124. Evolution of Salaries

In the region Ile-de-France, the hourly salaries recommended by the professional organisations were the following on 1st May, 1993:

	Monthly salary for 39 hours weekly		Min. hourly rate	
	Counted from 1.3.93	Counted from 1.10.93	Counted from 1.3.93	Counted from 1.10.93
Worker of Execution				
Position 1 :	5767.50 F	5767.50 F	34.127 F	34.127 F
Position 2 :	6316.00 F	6426.50 F	37.372 F	38.026 F
Professional Worker	6800.50 F	6920.75 F	40.239 F	40.951 F
Professional Companion Worker				
Position 1 :	7608.00 F	7744.50 F	45.017 F	45.825 F
Position 2 :	8254.00 F	8403.50 F	48.840 F	49.724 F
Master Worker of Team Leader				
Position 1 :	8900.00 F	9062.50 F	52.662 F	53.624 F
Position 2 :	9546.00 F	9721.50 F	86.485 F	57.523 F

Parallely, the S.M.I.C. passed successively:

- At 1.07.93, 34.06 F of 1 hour, namely 5756.14 F for 169 hours except for the young of less than 18 years for whom the remuneration will be the salary of the coefficient 150 namely 5605 F for 169 hrs. on the condition that they may have less than 6 months of professional practice.

- At 1.07.93, 34.83 F of 1 hour namely 5886.27 F for 169 hrs except for the young of less than 18 years for whom the minimum remuneration will be the salary of coefficient 150 namely 5767.50 F, provided that they may have less than 6 months of professional practice.

To the basic salary indicated above add different premiums/bonuses/allowances and compensations/allowances, namely among others:

- the extra money: 39 F per day as from 01.02.93 to 28.02.93; then 40 F as from 01.03.93 given to the salaried employee by a large number of enterprises;

- The transport and journey allowances; the employees benefiting from these allowances which are very variable, are less numerous.

- the antiquity allowance, etc.

125. Not utilised.

13. Fiscal Order

131. State taxes

131.1 Tax on the revenue: The exploiters of the enterprises of metal are subject to the tax on the revenue under the common law (categories of industrial and commercial profits).

131.2 Value added tax

a. Principle of taxation: The taxation system varies according to whether it is about the property works, the maintenance work or sales.

Considered as the property works are construction works of the buildings, the installation on buildings consisting of putting on work the elements which lose their personal character because of their incorporation in a fixed or real estate ensemble (immovable by nature), the repair works or of repair having for the object, the restoration of the building or the installation of a fixed nature.

The operations of simple maintenance which only imply the employment of minor supplies coming under the system of the benefit of services. However, when the operation of maintenance is the extension or the accessory of the work or of the repairing, it is subject to the same system as these works.

The installation of the objects or moveable machines which once laid, assume a personal character and are included in the sale of the materials of service benefits.

b. The department of work and demands: Conforming to the measures of the article 269 of C.G.I.

- The department of work is constituted.

* for the delivery and the purchasing by delivery of goods;

* for the benefits of services, including the property works by the execution of services and the works;

- The tax is required:

* for the delivery and the buying/purchasing mentioned above at the time of carrying out work.

* for the benefits of the services comprising of the fixed works at the time of encashing of the instalments/deposits, of the remuneration or on the authorisation of Director of Fiscal services according to the rates.

The enterpreneurs of the fixed work can in the conditions and for the works which are fixed by order opt for the payment of tax on the deliveries.

c. <u>Rate</u>:

1. <u>Intermediary rate</u>: it applies itself to the following operations:

* To the fixed works defined by the article 280 - 2F of C.G.I.

* to the maintenance operations when they are the extension or the accessory of repair work.

* to the delivery of services made by the debtors listed in the repertory of works - except for/with the exception of operations whose characteristics do not justify the audited registered list of persons who carry it out.

* to the set of operations other than the trade sales, carried out by the debtors listed in the repertory of works when the debtors are susceptible to the system benefits scheduled in the article 282-3 of C.G.I. or are placed by option under the simplified system of taxation (art. 230 2h of C.G.I.).

2. <u>Normal rate</u>: The operations other than cited above, are a matter for normal rate. It is reminded that since the 1st January, 1977, the normal rate is at the same level as the intermediary rate and they both are fixed at 18.60% since the 1st July, 1982.

131.3 and **131.4** - Not utilised.

132 - Not utilised.

2. **Determination and Reconstruction of Profits**
Control of Declared Results

21. **Reconstruction of Receipts**

211. Not utilised

212. **From the Paid Salary**

C.A. (H.T.) = (S + S1) x 3 + (M x 1.47) + (ST x 1.11) (I) (1)
C.A. (T.T.C.) = C.A. (H.T.) x 1.186

S = Paid salary; it is proper to take into account uniquely the salaries corresponding to productive work. It is specified that in the profession of building the paid holidays are paid by the autonomous cash desk and not by the employer, consequently one does not take into account their increase in the reconstruction.

S1 = Fictitious remuneration of the exploiter, the remuneration to hold back is the one corresponding to the time of the productive work of interest, which is in principle inversely proportional to the number of persons that it employs: the situation being very varied, it is impossible to fix in the same manner a percentage of unproductive time which must be determined in each case; in principal when the exploiter works alone the number of productive hours taken is 1700 hours and then in this case the estimated remuneration of the employer will then be obtained on multiplying 1700 by the hourly price of billing.

I = The CAPFB situates this coefficient around 1.44.

M = Price except T.V.A. of the supplies utilised.

ST = Sum excluding TVA of the memorandums of subcontract; the operations of subcontracting are practised only exceptionally by the taxpayer coming under the system of 'Forfait'.

213 and 214 Not utilised.

22. - Not utilised.

23. **Evaluation of Professional Costs/Taxes**

Taking into account the grand diversity of the conditions of running, it is not possible to indicate the percentage of professional valid taxes for the total work of the profession, this one depends in fact to a certain extent.

- on the quantity of utilised material;

- on the quantity and the nature of the work carried out (work of making and of installation of the repairing and maintenance work).

  However, the following details can be brought;

- the social and professional taxes on the salary actually represent around 80% of the salary.

- the attention is called to the non-negligible effect of the cost price of supplies which without being incorporated in the work are consumed - destroyed or lose their specific qualities during the operations (notably soldering work: electricity, petrol for (use of) generating set on the site, oxygen, acetylene; coal); these supplies generally figure not in the paragraph "purchasing" of the declaration No. 951 but in the para "other overheads" which justify the necessity to bring a particular attention to the information contained in this declaration.

24 to 29 - Not utilised.

3-4-5 - Not utilised.

APPENDIX IV

Region d'Ile-de-France 3 020 013

Delegation Regionale Des Impots

33, avenue de l'Opera - 75002 PARIS
2nd division

REGIONAL MONOGRAPHY

Profession : Restaurants

Code A.P.E. : 6701

The 'Forfait' must take into account the facts or realities of the small enterprises ar in particular, the evolution of margins in the considered activity and the taxes imposed on the enterprise.

The norms are subject to an adaptation to each enterprise on the basis of professional, national or regional monography, elaborated by the administration and communicated to the professional organisations which can present their observations.
(C.G.I. art. 302 ter - 2 bis).

I. General Informations

II. Professional Order

112. Characteristics of the Profession

In order to take into account the particular situation of the exploitation, the establishments are classified into four categories:-

a. The restaurants called 'workers restaurants' which do not offer a card, but one or more menus permitting to choose several dishes. The service, the category and the comfort are secondary.

The lowest price noted on September 1990 is 47F. The average priced hardly exceeds 50F.

b. The restaurants "one star": Restaurants, self-service or snacks serving a simple cuisine but of quality with the precise obligations of material level (A number of tables, coat racks, dishes/crockery of quality, sanitary appliances ....) or of professional level (notably, existence of a card, suggestion/offers of at least 3 culinary specialities, and of one of several menus, called 'touristique').

The average price of cheapest menu is around 70F. The price of meals do not generally exceed 250F.

c. The "gastronomiques restaurants" which present one or more menus, whose qualified cook makes the most important contribution to their turnover from the bill of fare.

This type of establishment, is not obliged to come under the system, of 'Forfait' due to the higher level of turnover.

Besides, it is made clear that in these restaurants the stocks of drinks (wines) are sometimes very important.

d. To these three categories, it is proper to add the one of 'fast-food restaurant'.

Besides, it is made clear that the purchasing of drinks is mostly from the wholesalers. The other foodstuffs are purchased either from the producers (case of strawberries for examples), or from the shopkeepers or traders (wholesalers or retailers). However, it is specified that in the rural zone, the direct purchase from the producers is more common.

Finally, reductions can be granted for group meals.

113 to 114 - Not utilised.

115. Conditions of Work

115.1 Types of suppliers: In catering activity there is no supplier credit. This is perhaps frequent in the cafeteria.

The interest rate for credit is the same as that of banking loans.

12. Economic Order

121-122 - Not utilised

123. System of Pricing

Since 1987, the prices had been entirely 'decontrolled' in this sector of activity.

1. According to INSEE, the evolution/development of the price index of "Hotels, cafe's, restaurants and canteens" had been following:

- Entire France
Basic 100 in 1980
168.8 in July 1985
176.1 in July 1986
188.3 in July 1987
198.7 in July 1988
208.7 in July 1989
217.3 in July 1990
232.3 in Aug. 1991
240.8 in June 1992

of the restaurants only:

194. in August 1988
209.3 in August 1989 namely an increase of 8%
214.3 in July 1990
225.8 in August 1991
233.2 in June 1992

<u>Paris region</u>

Hotels, restaurants, cafe's and canteens

206.4 in August 1989
217.7 in August 1990
228.5 in August 1991
237.1 in June 1992

of the restaurants only:

202.1 in August 1989
214.3 in August 1990
224.7 in August 1991
232.4 in June 1992

2. According to INSEE, the evolution of the general wholesale price index of basics on the public markets of Paris had been the following:

Basic 100 in 1962 (corrected for the seasonal variations).

461.1 in August 1988
512.3 in August 1989 (namely an increase of 11%)
531.9 in August 1990
536.8 in August 1991
500.4 in July 1992

124-125 - Not utilised

13. Fiscal Order

131. State Taxes

131.1 Tax on the income: The caterers are subjected either to the tax on the income (category of industrial and commercial benefits) or to the tax on the societies, under the common law.

131.2 Value Added Tax (T.V.A.): The consumer sale in the place of food and drinks are subject to TVA to an intermediary tax of 18.6% since 1.07.1982 (C.G.I. art 280-2-d).

Particularities of the fiscal regulations/control: The system of tips, and the conditions in which these are included in the turnovers, are explained in BODGI 3B-4-76. The allowance given by this instruction is not applicable to the sector of the fast-food restaurants where the tips are generally taxable to TVA - the tips considered like the salaries in view of the instruction previously cited are included for the purpose of imposition of professional tax.

For an establishment with the telephone in order to determine the taxable sum under this it is accepted that 31% of the total receipts from telephone are retained and these are included in the turnover.

Finally the products of plays and automatique apparatuses became liable to TVA since 1.7.85. These must be declared by the proprietor of the apparatus. This activity constitutes a separate sector whose operations must be charged separately. The rules concerning the imposition of T.V.A. as well as the deductions figure in the instruction of 12-6-85 (BODGI-3-A-12-85).

The restaurant owners authorised to go back to the the system of regulated price, increase the supplement in the name of the remuneration of their services which must be reported for T.V.A.

1313 - 1314 - Not utilised.

132 - Not utilised.

2. Determination and Reconstruction of Profits

For the reconstruction of turnover; it is proper to take into account the following principal elements:

- Category and location of the establishment
- nature of the clientele;
- existence of menus or service (of bill of fare).

The free determination of prices since 1987 is accompanied by successive accords of the regulations signed with the profession which permit only a modulated evolution of gross margins; from where the previous coefficients are renewed.

21. Reconstruction of Receipts (TTC)

Conforming to the memorandum of 21st June 1989, the receipt had been examined excluding T.V.A.

211. From Utilised Purchasing Before Tax

The turnover before tax will be calculated by applying the following multipliers to the purchasing -

Worker's restaurants	: 1.70 to 2.30 dominant value 2.
Middle-class restaurants	: 2.30 to 3.60 dominant value 2.80
Gastronomique restaurants	: 2.60 to 3.20 dominant value 2.80
Fast-food restaurants	: 1.50 to 2.30 dominant value 2.10

NOTE: Besides the large/grand diversity of locations, it must be noted that for the establishments of the first category ('workers restaurant') the drinks are often included in the price of menu, which reduces the margin.

212 Reconstruction of Turnover Before Tax from the Utilised Purchasing Breakdown

	Workers	Middle class	'GASTRO'	Fast-food
Solid food stuffs	1.60 to 2.30	1.80 to 3.80	2.60 to 3.20	1.40 to 2.70
Wines, standard consumption	2.00 to 2.40	2.60	-	1.40 to 2.30
Wines AOC	-	2.10 to 3.50	3.00 to 3.50	
Drinks in general	-	-	-	3

For the establishments of the first, 2 categories (workers and middle) it is noted that the retailing of ordinary wine "in jug" or of wine classified "reserve of the establishment" in bottle gave a very good return.

The margins can be superior than the one analysed above.

To reconstruct the receipts, it is proper to take into account:

- The dimension/size of the establishment, their location and their frequency, the quality of service provided and the prices demanded, that is to say the essential/basic elements which influence the gross margin.

- The secondary takings such as bar, plays, tobaccoes, telephone, having observed that the surcharge (cf. IIIrd part) is not applicable in all the establishments.

- No. of banquets which can be served and the reductions/allowances of price which are eventually consented to on these occasions.

- The personnel employed when the labourer is familiar, the output/yield is generally improved.

- The date of closing of the establishment; the opening on sunday permits serving of the meals at a little higher price on this day.

- The seasonal character of the exploitation.

To determine their prices, the professionals retain the following formula:-

Price = (Products x 33%) + (labourer x 45%) + (overheads x 15%)
+ employer's margin x 7%)

The service charges - 10 to 15% - tend to disappear, the prices being more and more considered like the net prices.

The number of meals can be evaluated from:

- The number of days it is opened. The establishments employing the personnel are opened on average 282 days per year (one day of closing weekly and 5 weeks of annual holidays).

- The personnel employed to service. In the restaurant of the 'worker's' category, a person can serve 30 to 50 meals,

The quantity of wine consumed. The average consumption of wine per meal is of the order of 0.30 ltr. and 15% of meals are served without wine. The no. of meals calculates itself from the following formula:

$$\text{No. of meals} = \frac{1.18 \times \text{Quantity of consumed wine}}{0.30 \text{ ltr.}}$$

213. Effect on the Profession of the Crisis of Gulf and its Repercussions

Despite the liberty of the management since 1987 and the removal of the taxation of overheads, the professional organisation noticed a low/weak evolution of profit margins due to the reduction of the purchasing power of the clientele.

The gulf war led the syndicate national to put in place monthly observatory which brought out the following results.

	Restaurants		Sale of drinks	
	Frequency %	Turnover %	Frequency %	Turnover %
February'91	- 17.02	- 16.39	- 16.39	- 14.50
March'91	- 8.93	- 8.67	Responses in insufficient number	
April'91	- 3.49	- 3.63		
May'91	+1.56	- 6.86		
From June' 90 to June'91				
Comparison over 12 months	- 2.19	- 1.20	- 3.52	- 4.69

214. - Not utilised.

22. Calculation of Gross Profit

The profit is very variable according to the competence of the exploitant and the cook as well as the place of exploitation and the clientele.

The mode of billing of the drink also has its importance. When the price is included in the price of menu, the margin is diminished. On the contrary, the sale of ordinary drinks in jugs or classified "reserve of the establishment" increases margin.

23 to 29 - Not utilised.

3-4-5 - Not utilised.