12

Presumptive Taxation

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> Acetylene, Achievement awards, Acts of God, Affidavits, Age 55 or over, Age 65 or over, Agricultural irrigation projects, Agricultural labor, Aircraft, Air force, Alaska, Alcohol fuel credit, Aliens, Alimony and separate maintenance payments, Alternative minimum tax, Ambulances, Ammonia, Amortization, Amusement expenses, Anti-cruelty organizations, Apostolic associations, Apothecaries, Aquatic resources trust fund, Arbitrage bonds,...
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> —Index to Internal Revenue Code (Research Institute of America 1993).

I. General Concepts

Presumptive taxation involves the use of indirect means to ascertain tax liability, which differ from the usual rules based on the taxpayer's accounts.[1] The term "presumptive" is used to indicate that there is a legal presumption that the taxpayer's income is no less than the amount resulting from application of the indirect method. As discussed below, this presumption may or may not be rebuttable. The concept covers a wide variety of alternative means of determining the tax base, ranging from methods of reconstructing income based on administrative practice, which can be rebutted by the taxpayer, to true minimum taxes with tax bases specified in legislation.[2]

This concept does not cover all instances of the use of legal presumptions in taxation. More generally, a presumption can be said to be involved anytime a mechanical definition is used in place of a more open-ended rule based on the facts and

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

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

circumstances of each case. The focus in this chapter is the use of a presumption to supplant the entire tax base, or an entire category of taxable income.

Presumptive techniques may be employed for a variety of reasons.[3] One is simplification, particularly in relation to the compliance burden on taxpayers with very low turnover (and the corresponding administrative burden of auditing such taxpayers). A second is to combat tax avoidance or evasion (which works only if the indicators on which the presumption is based are more difficult to hide than those forming the basis for accounting records). Third, by providing objective indicators for tax assessment, presumptive methods may lead to a more equitable distribution of the tax burden, when normal accounts-based methods are unreliable because of problems of taxpayer compliance or administrative corruption. Fourth, rebuttable presumptions can encourage taxpayers to keep proper accounts, because they subject taxpayers to a possibly higher tax burden in the absence of such accounts. Fifth, presumptions of the exclusive type (see below) can be considered desirable because of their incentive effects—a taxpayer who earns more income will not have to pay more tax. Finally, presumptions that serve as minimum taxes may be justified by a combination of reasons (revenue need, fairness concerns, and political or technical difficulty in addressing certain problems directly as opposed to doing so through a minimum tax).

This chapter deals with certain minimum taxes but does not discuss minimum taxes in general. Some minimum taxes are accounts-based taxes; they involve the use of different accounting methods than regular tax or they may involve the denial of certain deductions. These types of minimum taxes, along with the general concept of minimum taxation, are beyond the scope of this chapter.

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

The extent to which presumptive taxes are used varies greatly from country to country. Some countries (e.g., the United States) employ almost no presumptive taxation,[4] while others (e.g., France[5]) use presumptive taxes extensively.

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[3]*See* Lapidoth, *supra* note 2, at 25.

[4]The main exception being rebuttable methods used as an alternative means of assessment. *See infra* sec. II(A). The United States has for about 30 years used minimum taxes involving calculation of the tax base according to accounting methods different from those used for the regular tax. As mentioned, this type of accounts-based minimum tax is beyond the scope of this chapter.

[5]In France, the importance of presumptive taxation is on the decline, compared with a few decades ago. *See infra* sec. III(D)(2).

Possible legal constraints on the adoption of presumptive methods should be considered in drafting legislation for their application, including constitutional constraints, such as equality before the law and a prohibition on confiscation of property.[6] They might also include obligations under international agreements. For example, some double tax treaties may prohibit taxing a nonresident on a presumptive basis without allowing the taxpayer to prove its actual income and be taxed accordingly.[7]

The use of withholding taxes is sometimes discussed together with presumptive techniques. Withholding taxes can also achieve the effect of taxation based on an alternative simplified base. Withholding is commonly used for the income tax and is usually based on the gross amount of a payment. Withholding can also be imposed on other bases, for example, on the amount of imported goods, with a credit allowed against income tax. The legal nature of withholding taxes is normally not the same as that of presumptions, because taxpayers normally have the right to file a return and receive a refund of excess amounts withheld. Therefore, although there is some commonality between withholding and presumptive techniques, the former is not considered in this chapter. If taxpayers are not given the right to claim a refund, then the withholding tax is in effect a minimum tax collected by withholding, which does not differ conceptually from other minimum taxes.

II. Legal Characteristics of Presumptive Methods

A. Rebuttable vs. Irrebuttable

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

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

Rebuttable presumptive assessments are a universal feature of tax assessment procedure, required in order to deal with cases where taxpayers either do not fully disclose their financial situations on their returns or fail to file a return. In these cases, the law normally authorizes the tax authority to use indirect methods to determine the

[6]*See supra* ch. 2, sec. II; *infra* note 40.

[7]*See* OECD Model Convention art. 7(1), *reprinted in* Klaus Vogel, Double Taxation Conventions 308 (1991); U.N. Model Convention art. 7(1), *reprinted in id.,* at 309; U.S. Model Convention 7(1), *reprinted in id*. These provisions allow taxation of only the profits that are attributable to a permanent establishment. Imposition of a presumptive tax might result in a tax even where there are no such profits, and might therefore violate the treaty, if the presumptive tax is a tax covered by the treaty.

taxpayer's income, based perhaps on arbitrary criteria or on whatever data are available. Because presumptive assessment is intended as a means of ascertaining the taxpayer's income in the face of inadequate data, the taxpayer should be allowed to present better data to refute the determination of the tax authorities. This type of presumptive assessment therefore does not represent a fundamental departure from the normal rules for determining tax liability, but is a fallback when these rules do not work because of noncompliance by the taxpayer.

The *forfait* applicable in France[8] is a hybrid between rebuttable and irrebuttable methods. It is rebuttable in the sense that the taxpayer may elect to use the normal accounting rules instead of the *forfait*. Under the *forfait,* the determination of income is a matter of negotiation between the taxpayer and the tax inspector. However, once it is agreed on for the specified period of two years, it applies automatically regardless of the taxpayer's actual income for the period.

B. Minimum Tax vs. Exclusive

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

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

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

While exclusive presumptions have the advantage of simplicity and minimal disincentive effects, they suffer from a lack of equity. Taxpayers with substantially differing amounts of actual income must pay the same amount of tax if their presumptive tax base is the same.

C. Mechanical vs. Discretionary

[8] *See infra* sec. III(D)(2).

Presumptive methods can also be distinguished according to the degree of discretion that they allow tax officials. Some presumptive methods are quite mechanical, allowing no discretion, for example, methods based on a percentage of gross receipts or of a firm's assets. Other methods, such as the net worth method,[9] involve a large degree of discretion for the agent applying them.

Methods involving a large measure of discretion will generally be rebuttable, because otherwise too much power, and potential for arbitrary action, would be given to the revenue authorities. Mechanical methods may or may not be rebuttable. In some cases, a method will be mechanical (and irrebuttable) if applied, but the tax authorities have discretion as to whether to apply it. This was the case, for example, with the presumption based on signs of lifestyle in France, which was irrebuttable (although it has subsequently been changed to a rebuttable presumption). Tax agents were directed not to apply the presumption when its application would be harsh, although they were not legally bound to refrain from applying the method.[10] A taxpayer could perhaps in rare cases successfully argue that being subjected to the presumption constituted an abuse of discretion if the presumption were being applied under circumstances where the tax authorities were instructed generally not to apply it.

As in other areas of tax law, the choice between mechanical and discretionary rules will involve factors such as the following: the potential for corruption in the case of discretionary rules, the potential harshness of mechanical rules, the reduced administrative resources needed to apply mechanical rules, and the potential for expressing the particular matter as a mechanical rule.

D. Scope of Application

Presumptive taxation is commonly used in the context of the income tax. Some presumptive methods completely supplant the income tax for particular taxpayers. In other cases, the presumptive method may determine a portion of the tax base, for example, the income from a particular business or agricultural activity. Presumptions are also used for taxes other than the income tax. Thus, the *forfait* methods for small traders often cover both income tax and VAT liability.[11] Presumptive methods have also been used for the excise tax.[12]

E. Taxpayers Targeted

Presumptive methods can be distinguished according to the types of taxpayers who are targeted. In general terms, three groups of taxpayers have been the source of problems

[9] *See infra* sec. III(A)(2).

[10] *See infra* sec. III(E).

[11] *See* FRA CGI arts. 50, 265; ESP IVA art. 122 *et seq.*; VAT Regulations arts. 34—42 (ESP), *reprinted in* 2 Leyes Tributarias: Legislación Básica 1298–1305 (5th ed. 1992).

[12] *See* Sijbren Cnossen, Excise Systems: A Global Study of the Selective Taxation of Goods and Services 74–83 (1977).

against which presumptive methods have been directed. The most common problem is noncompliance by small businesses and professionals. A second problem is noncompliance by individuals (this may be related to the first, but the focus is on amounts that individuals have taken out of their businesses or received from other sources and used for consumption). A third group of targeted taxpayers is businesses as a whole, including large companies.

The appropriate design of a presumption will depend on the particular problems it is seeking to address. Therefore, before a particular presumptive method can be recommended or designed for a specific country, it is necessary to ascertain what types of taxpayers are giving rise to problems under the normal rules for determining the tax base and the nature of those problems. Presumptive taxation may or may not be an appropriate solution. For example, if a particular group of taxpayers is unable to comply with the tax system, consideration should be given to whether it is possible to remove that group from the tax system altogether.

III. Particular Presumptive Methods

A. Reconstruction of Income

1. In General

If the taxpayer has failed to file a return or has substantially understated his or her income, and the transactions giving rise to income cannot be traced, the tax authorities are usually authorized to assess income on their best judgment. This could involve use of a method such as net worth, or bank deposits, or some other approach that has a factual basis for the particular case. As long as the assessment is based on reasonable facts, it will be upheld, subject to the taxpayer's right to come forward with proper evidence of income; no specific methodology is prescribed.[13]

The legal authority to make best judgment assessments is usually provided in general terms in the statute. In some countries, there are no particular thresholds for use of indirect methods. Thus, in Israel, the assessing officer has the power to "determine to the best of his judgment the amount of the person's chargeable income and assess him accordingly, if he has reasonable grounds for believing that the return is not correct."[14] In

[13]"The Officer is to make an assessment to the best of his judgment against a person who is in default as regards supplying information. He must not act dishonestly or vindictively or capriciously, because he must exercise judgment in the matter. He must make what he honestly believes to be a fair estimate of the proper figure of assessment, and for this purpose he must, their Lordships think, be able to take into consideration local knowledge and repute in regard to the assessee's circumstances, and his own knowledge of previous returns by and assessments of the assessee, and all other matters which he thinks will assist him in arriving at a fair and proper estimate; and though there must necessarily be guess-work in the matter, it must be honest guess-work. In that sense, too, the assessment must be to some extent arbitrary." 1 N.A. Palkhivala & B.A. Palkhivala, Kanga and Palkhivala's The Law and Practice of Income Tax 1154 (1990) (quoting CIT v. Laxminarain Badridas, 5 ITR 170, 180 (1937)).

[14]ISR IT § 145(2)(b).

the United States, the Internal Revenue Code gives the IRS general authority to make assessments and determine deficiencies in tax;[15] no distinction is drawn in the statute between direct and indirect methods of determining a deficiency.[16] The permissible bases for proving a deficiency using indirect methods have been elaborated in judicial decisions.[17]

In other countries, indirect methods may be applied only under certain circumstances specified in the statute. In India, the statute requires best judgment assessments when the taxpayer has failed to file a return or to produce information, and authorizes such assessments when the taxpayer's accounts are incorrect or incomplete or when no method of accounting has been regularly employed by the taxpayer.[18] In Argentina, the *determinación de oficio* applies whenever the taxpayer has failed to file a return or when the return is inadequate.[19] In France, the procedures for *imposition d'office* are set forth in the *Livre des procédures fiscales*.[20] This procedure applies when the taxpayer has failed to file a return, has failed to furnish information to the tax authorities upon request, or in the case of a nonresident taxpayer, has failed to designate a representative in France.

The drafter of statutory authority for indirect methods must make a basic choice between a general authority (which provides the greatest flexibility to the tax administration) and a restricted authority (which may provide procedural defenses to the taxpayer). If a restricted authority is chosen, it should be drafted in such a way as to minimize disputes between the taxpayer and tax authorities as to its application.

Under normal circumstances, a tax administration can afford to process relatively few cases on the basis of indirect methods of proof because of their labor intensity. However, the threat of a best judgment assessment can be used against nonfilers (or those who file obviously inadequate returns): an assessment can be made on a very crude basis, not to develop an accurate determination of income, but to induce the taxpayer to come forward with a complete return. This power has been misused in some countries whose tax administrations rely too heavily on the best judgment assessment, with a consequent possibility of corruption. To prevent this type of problem, supervisors in the tax authority should monitor the use of best judgment assessments.

2. Net Worth Method

[15]*See* USA IRC §§ 6201, 6204, 6212.

[16]*See* Holland v. United States, 348 U.S. 121, 131–32 (1954) (use of net worth method not restricted to cases where the taxpayer kept no books).

[17]*See id.* at 124–29 (discussing matters where exercise of care is needed in applying the net worth method in criminal prosecutions for tax evasion).

[18]*See* IND IT §§ 144, 145(2).

[19]*See* ARG APFI art. 23.

[20]*See* Livre des Procédures Fiscales, arts. L. 65– L. 76A. *See generally La Taxation d'office à l'impôt sur le revenu,* 31 Annales de la Faculté de Droit et des Sciences Politiques et de l'Institut de Recherches Juridiques, Politiques et Sociales de Strasbourg (1980) (*Taxation d'office* is a form of *imposition d'office*.)

In the absence of substantial information about the taxpayer's actual income, a commonly employed method is to estimate income by determining the change in the taxpayer's net worth over the year and adding to this amount the estimated personal consumption expenses, determined by examining the taxpayer's lifestyle.[21] In principle, any use of funds other than those that would be reflected in increased net worth should be included as personal consumption expenses for this purpose (e.g., gifts made to others). As a matter of income tax theory, this approach cannot be faulted, since income can be defined as consumption plus change in net worth.[22]Victor Thuronyi, *The Concept of Income,* 46 Tax Law Review 45 (1990). The difficulty is typically the lack of evidence and the consequent need to make rather imprecise estimates. Courts have nevertheless allowed this method to be used on the basis that the taxpayer brought it on him- or herself by failing to furnish particulars of the taxpayer's income.

The net worth method is often not based on specific statutory authority, but rests on the broad power of the tax administration to make best judgment assessments.[23] Some countries have codified the net worth method, but sometimes with insufficient attention to the details of its operation. For example, in Colombia a rebuttable presumption stipulates that income is no less than the increase in net worth, reduced by items of exempt income. However, this formula fails to take into account consumption, so that it results in a substantial understatement of income where, as is usual, most of the taxpayer's income is consumed.[24] In India, the Income Tax Act specifically states that if, in any financial year, a taxpayer is found to be the owner of money, cash credits, property, or other investments and cannot explain their source, then their value may be assessed as income for that financial year.[25]

In terms of the typology set forth above, the net worth method is usually rebuttable; it replaces the entire tax base; and it involves a limited but still substantial degree of discretion, in that the reconstruction of net worth at the beginning and end of the year, and of consumption expenses during the year, requires the exercise of judgment. The taxpayer is normally allowed to rebut the results under the net worth method, either by furnishing full details and evidence of actual receipts or by showing that the consumption plus increase in net worth was financed by nontaxable receipts (e.g., gifts, bequests, or, in a country with a territorial system, foreign-source income).

The net worth method is labor intensive, requires sophisticated auditors, and is therefore not suited for mass application. The elements on which it rests are often

[21]*See* Annotation, Use of Net Worth Method in Prosecution for Evasion of Federal Income Tax, 99 L. Ed. 167 (1955).

[22]*See* Henry Simons, Personal Income Taxation 50 (1938). *See also*

[23]*See* Lapidoth, *supra* note 2, at 110.

[24]*See* Charles E. McLure, Jr. et al., The Taxation of Income from Business and Capital in Colombia 47, 144–45 (1990).

[25]*See* IND IT §§ 68-69B; Palkhivala, *supra* note 13, at 863–69; Lapidoth, *supra* note 2, at 114–17.

difficult to apply, requiring information on the taxpayer's wealth holdings and consumption expenditures in a situation where by hypothesis the taxpayer has not been cooperative in furnishing information. Rather, it can be used to go after a few taxpayers who have totally failed to comply with their tax obligations. It cannot be relied on as a significant revenue source in itself, and is better thought of as part of the arsenal of tools that can be used to induce compliance. These observations apply with equal force to the bank deposit method and the expenditures method, described below.

3. Bank Deposit Method

Another method auditors use to determine income in the absence of an adequate declaration is to secure records of deposits into the taxpayer's bank accounts (in both foreign and domestic banks) and to presume, unless the taxpayer can show the contrary, that the deposits constitute income. Depending on the taxpayer's financial and business practices, this can, of course, lead to either a grossly exaggerated or a grossly understated estimate of net income.[26] Nevertheless, courts have allowed this method of estimating income, again on the principle that if the taxpayer considers it unfair, he or she can furnish details of actual income.[27]

The effectiveness of this method obviously depends on the state of development of a country's financial institutions. In countries where most amounts are transferred in cash, it is not likely to be very helpful.

4. Expenditures Method

When evidence of the taxpayer's net worth is not available, income can be presumed on the basis of total cash expenditures. In countries where methods of indirect proof of income are not codified, this can be one possible approach under the authority to make best judgment assessments. It may be impossible to use the net worth method because evidence of net worth is unavailable. In some countries, taxation on the basis of personal expenditures has been codified, in which case a difference in result can occur from the best judgment assessment in the sense that personal expenditures, instead of being an indirect method of proving taxable income, become a tax base in their own right in situations contemplated by the statute.[28] Previously in France, individuals could be taxed on the basis of their "open and notorious" personal expenditures,[29] but this method has now been repealed.[30] A similar rule has also been repealed in Germany.[31]

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[26]A substantial underestimate results in cases where most of the taxpayer's income is received in cash and never finds its way into the taxpayer's bank account. An overestimate results where the deposits reflect gross receipts or transfers from other accounts.

[27]*See* Michael I. Saltzman, IRS Practice and Procedure ¶ 7A.02[1][d] (2nd ed. 1991).

[28]*See* Lapidoth, *supra* note 2, at 60–63.

[29]*See id.* at 61-63. *See* FRA CGI former art. 180, then LPF art. L 71.

[30]*See* Loi No. 86-1315 du 30 décembre 1986, art. 82-11.

[31]DEU EStG § 48. *See* International Program in Taxation, Harvard Law School, World Tax Series: Taxation in Germany 325-26 (1963).

B. Percentage of Gross Receipts

The legislation of some countries[32] provides a minimum-tax type of presumption, whereby the taxable income of a business can be no less than a specified percentage of the gross receipts of the business. For businesses paying tax on this basis, the tax has the same economic effects as a turnover tax, rather than an income tax, although the situation is more complicated when a company alternates between paying tax on gross receipts and paying tax on income.

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

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

A further problem with this type of minimum tax is that there is no close correlation between a particular year's income and turnover.[33] Moreover, net income is likely to represent widely varying percentages of gross receipts depending on the industry concerned, the degree of integration of the particular enterprise, and the type of product or service provided (e.g., a boutique may require a higher profit margin to cover its costs than a high-volume sales operation). Using the same percentage for all companies will therefore be highly inaccurate as a means of approximating net income.

The problem can be addressed, as some countries have done, by classifying taxpayers according to their business and by specifying a profit percentage to be applied to gross receipts, based on industry studies for each type of business to be covered.[34] This kind of presumption can be applied as an exclusive way of taxing income, as a minimum tax, or as a *forfait*. This more sophisticated approach reduces the inaccuracy of the presumption, but makes it more complicated to apply, particularly to taxpayers whose

[32] *E.g.,* SLE IT § 23; COL ET § 180, 188 (repealed as of 1990).

[33] *See* McLure et al., *supra* note 24, at 144.

[34] *See infra* sec. III(D)(3).

operations cross industry lines. Moreover, to be accurate this method requires research into actual profit margins, an effort that involves significant resources and may be difficult to accomplish in conditions of general economic instability. Therefore, it would be more suitable for some countries than for others.

The receipts-based presumptive tax can also encounter enforcement problems and result in unevenness of application. If taxpayers fail to declare their gross receipts, they can avoid the presumption. So the basic audit problem of determining gross receipts is not addressed by this type of tax. Accordingly, it is not likely to be effective in raising revenue from the types of taxpayers whose gross receipts are difficult to ascertain, such as independent professionals, and is more likely to impinge on those taxpayers who cannot hide their gross receipts.

As with other minimum taxes, the apparent simplicity of the receipts-based minimum tax is undermined by the need to make complicated adjustments for taxpayers who alternate between paying tax on a presumptive basis and paying the regular income tax.[35] If such adjustments are not made, then the presumptive regime can involve a disproportionally high tax liability for taxpayers whose income tends to fluctuate substantially from year to year.

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

An alternative that some countries have adopted[36] is to make the gross receipts presumption rebuttable. Although this alternative takes care of many of the problems of the gross receipts tax, it also takes most of the teeth out of this type of minimum tax.

C. Percentage of Assets

[35]*See* McLure et al., *supra* note 24, at 142–43. *See also infra* sec. III(C)(6)(b).

[36]*E.g.,* SLE IT § 23(3).

Several countries, including Argentina, Colombia, Mexico, and Venezuela, have adopted minimum taxes based on a fixed percentage of the assets of a business.[37] In Bolivia, such a tax replaced for a time the corporate income tax; that is, it was an exclusive presumption.[38] The tax base varies from gross assets (Argentina) to net assets—assets minus debts (Colombia)—with the Mexican tax taking a middle position whereby certain debts are deductible. The economic rationale for the assets tax is that investors can expect ex ante to earn a specified average rate of return on their assets. Of course, such taxation could be considered unfair because the ex post return will differ from what was expected. Moreover, the minimum asset tax can discourage risky investments under circumstances where it denies the taxpayer the benefits of carrying over the losses resulting from the investment.

To evaluate whether it makes sense to have an assets tax and how such a tax should be designed, it is necessary to establish the purpose that such a tax is to serve. An assets tax can be justified as a permanent part of the tax system only if it can help resolve problems with the administration of the income tax that are difficult to address directly.

For example, the assets tax might be useful as an indirect way of addressing transfer pricing problems. Suppose that the tax administration finds it difficult to police transfer pricing cases directly and that multinationals are using transfer pricing to seriously undercut the tax base. The assets tax allows the collection of revenue regardless of reported transfer prices. However, this strategy works only if the resident companies subject to the assets tax have substantial assets in the country. Often, the problem with transfer pricing cases is the existence of intangible values that are not included in the balance sheet of the domestic subsidiary. Moreover, the question can be raised whether the relatively narrow problem of transfer pricing warrants such a broad response.

In addition to transfer pricing problems, the income tax may suffer from generalized underreporting of income and other evasion. If so, the assets tax may help, the question being whether the same conditions that allow evasion of the income tax would also allow evasion of the assets tax. For example, if the basic problem is corruption of tax inspectors, it is unlikely that introducing an assets tax will correct the problem, because inspectors can be bribed in the same manner under both legislative schemes.

Finally, the assets tax may be used to address problems of timing in the income tax.[39] Under the general assumption that over the long term a holder of wealth would expect to earn at least the risk-free rate of return on that wealth, the assets tax is a reasonable proxy for ex ante economic income, while the accounting rules for the income tax may lead to deferral of that income. Despite its theoretical underpinnings, this

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[37]The assets tax came into effect in 1989 in Mexico, 1990 in Argentina, 1974 in Colombia, and 1993 in Venezuela.

[38]*See* BOL IRPE. The tax on presumed income was replaced by a tax on business profits at the end of 1994. *See* Gonzalo Ruiz Ballivián, *Bolivia Introduces General Profits Tax*, 11 Tax Notes Int'l 1087 (1995).

[39]*See* McLure et al., *supra* note 24, at 140.

argument has two principal flaws: (1) it leads to taxation of ex ante income, while fairness considerations call for taxing ex post income, and (2) it depends on a reliable valuation of the taxpayer's wealth. Moreover, this argument would justify a tax based on net assets, not on gross assets.

The specific design questions that come up for the assets tax will differ from case to case, but some common issues are highlighted in the following sections. The discussion is relatively more detailed than in the rest of the chapter, given the complexity of the drafting issues involved.

1. Gross or Net Assets?

Perhaps the most critical question in designing the assets tax base is whether there is to be any deduction for debt. Argentina has provided no deduction for debt. In Mexico, debts to resident companies (other than financial institutions) are generally deductible and financial institutions are exempt from the assets tax.[40] The net worth tax in Colombia allows a full deduction for debt.

Because the assets tax serves as a backstop for the income tax, it makes sense to coordinate the rules for deducting interest between the two taxes. If thin capitalization is perceived as a problem under the income tax, the appropriate remedy is to fashion limitations on the deduction of interest under the income tax. Corresponding rules can apply for purposes of the assets tax. For example, there can be a concern that loans from related foreign persons are in the nature of equity rather than debt, or that certain loans are fraudulent. If these concerns justify denying a deduction for these loans under the assets tax, they would presumably also justify a denial of the deduction for interest on these loans for income tax purposes.

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[40]Except for the tax on leased property and inventories. In a decision of Feb. 22, 1996, the Supreme Court of Justice of Mexico held the exemption of financial institutions from the assets tax to be unconstitutional. Article 31 of the Constitution provides that all are equal before the law. The court found that, in tax matters, the legislator can only draw distinctions if these are based on an objective and reasonable ground. The court found that there was no distinction between financial institutions and other companies that could justify exemption of the former. The dissent argued that an important purpose of the assets tax was to serve as a minimum tax for the income tax. Because financial institutions were under strict supervision of the financial authorities, their latitude to minimize their income tax liability was minimal. Therefore the legislator could rationally exempt them from the asset tax. While this argument has some merit, the majority pointed out that financial supervision did not completely rule out tax avoidance on the part of financial institutions and moreover did not justify exemption from the tax, since the tax had a revenue-raising purpose beyond safeguarding the income tax. In my view, the Mexican court failed to adequately examine the operation of the assets tax as a whole. Exemption of financial institutions (coupled with nondeductibility of debt to such institutions) is a rational legislative approach that should pass muster under the principle of equality. The opinion illustrates that courts often have difficulty in dealing with matters of tax policy and further illustrates that it is easy to justify both sides of an argument about whether a distinction made for tax purposes can be justified under the principle of equality. If courts are willing to test tax laws against the principle of equality in a vigorous manner, many aspects of tax legislation could be overturned by the courts. The decision of the Mexican court on the assets tax shows that seriously misguided results can be reached in cases of this kind. One possible legislative defense against such an eventuality is to spell out in a preamble or in explanatory material the justification for any provisions that may be considered discriminatory.

Mexico's approach in allowing a deduction for debts except those to financial institutions, and then exempting financial institutions from assets tax, maintains the aggregate assets tax base at a value equal to total assets in the corporate sector. The size of the total assets tax base is not too relevant, however, because many companies are in a position of paying income tax, rather than assets tax. Moreover, the Mexican rules can give rise to tax planning opportunities. A company that pays assets tax rather than income tax and that is indebted to a financial institution can instead borrow from a company that pays income tax, who would in turn borrow from the financial institution (the transaction would have no effect on the income tax liability of either company). Net lending from the banking sector would be the same. The debt of the assets tax payer would now be deductible. The lender's assets tax base would increase, but its tax liability would not, as long as it remained in a position of paying income tax rather than assets tax.

If it is decided to impose the assets tax on gross assets, then it would be necessary to provide an exemption for financial institutions, which would otherwise be subject to a huge tax burden.

2. Who Is the Taxpayer?

The specification of the taxpayer and the tax base should also be linked to the purpose of the tax. If the purpose of the assets tax is to serve as a minimum income tax for taxpayers with business income, then the taxpayers and assets within the scope of the tax should be specified accordingly.

For example, the Mexican tax applies to resident physical persons on all their assets used in a business, as well as to all the assets of resident juridical persons. It extends to assets wherever located (this is consistent with the income tax being based on worldwide income). The tax also applies to the assets of a nonresident's permanent establishment in Mexico.[41]

3. Tax Rate

If a tax on gross assets were applied in lieu of an income tax, setting the rate would be a relatively precise exercise, designed to capture the average rate of return on assets. When the tax is a minimum tax, however, there is a much greater scope for maneuver in setting the tax rate. The higher the rate, the larger the number of enterprises that will be subject to the minimum tax, as opposed to the regular tax. The tax rate is 2 percent in Mexico and Argentina and 1 percent in Venezuela.

4. Tax Base

[41]MEX ATL art. 1. The term "nonresidents" presumably encompasses both physical and juridical persons. Nonresidents without a permanent establishment (P.E.) are nevertheless subject to tax in Mexico on inventory to be processed in Mexico. *Id.* This provision is no doubt directed at companies who plan their affairs so as to avoid being treated as having a permanent establishment in Mexico. If they did have one, then its inventory would be subject to assets tax, whereas if they avoid P.E. status no one would, absent this rule, have to pay assets tax with respect to this inventory.

Assuming that the assets tax serves as a minimum tax for business income, the tax base should include all assets used in the business.

a. Average Value vs. Opening or Closing Balance

A key issue is when the assets are to be valued. The simplest approach is to value the assets at the beginning or the end of the year. If this rule were adopted, however, taxpayers could engage in window dressing. Companies who are assets tax payers could shift assets for one day to companies who are income tax payers.[42] Moreover, either beginning-of-year or end-of-year valuation will lead to some inaccuracy if it is not representative of the value of income-generating assets over the course of the year.

Accordingly, the tax base in Mexico is the average value of assets. The use of average values leads to a more accurate application of the tax; if there were a substantial change in a firm's assets during the course of a year, it would be unfair to base the tax for the entire year on the opening asset value.

Valuing assets on the basis of average value leads to complexity, although the additional complexity involved is minimized to the extent that the same rules are used for the assets tax as for the income tax generally.

In Mexico, for example, financial assets are generally valued according to average monthly value (based on value at the beginning and end of the month). Financial assets expressed in terms of foreign currency are valued at the exchange rate prevailing at the beginning of each month. Fixed assets are valued as for income tax purposes, including an adjustment for inflation, and taking into account only a pro rata share of assets that are acquired or disposed of during the course of the year. Inventory is taken into account at the average of closing and opening inventory value for the taxable year.

b. Integration

Should the assets tax base include shares or other interests in legal persons that are themselves assets tax payers? To include such interests seems to be double counting, in that the underlying assets of a business would be counted twice (or more than twice if there are additional tiers of corporate ownership). Whether this is appropriate should be determined with reference to the corporate integration rules of the income tax. For example, under a system whereby intercorporate dividends are fully taxed, including corporate shares in the assets tax base would be consistent with the income tax treatment. By contrast, under a system where corporations obtain a full exclusion for dividends received for income tax purposes, shares in domestic corporations should also be excluded from the assets tax base. If there is only partial integration, then only a partial

[42]For example, a company with too many assets could sell some assets to an income taxpayer. The sales proceeds could be used to pay off nondeductible bank debt. The transaction could then be reversed on the following day. Such a transaction might, of course, be subject to legal challenge under abuse-of-law or other anti-avoidance rules. *See supra* ch. 2, sec. III.

exclusion would be appropriate. In Argentina[43] and Mexico,[44] shares in domestic companies, that is, companies that are themselves subject to assets tax, are excluded from the shareholder's tax base.

c. Leasing

In the absence of special rules for leasing, taxpayers can avoid the assets tax by leasing property instead of purchasing it. The lessor could be a company that pays income tax rather than assets tax, and that is therefore indifferent to the increase in its assets tax base resulting from the lease transaction. Assuming debt finance, the two options of leasing or buying property can be economically very similar, but they will have completely different tax consequences for purposes of the assets tax, if the debt is not deductible from the tax base. If a company leases an asset, the asset will show up among the assets of the lessor and will hence be included in the overall assets tax base unless the lessor is not an assets tax payer. The lessor could, for example, be a foreign company, an exempt organization, or an individual not in the business of leasing. Partly forestalling this avoidance possibility, the Mexican law subjects to the assets tax a person who otherwise would not be subject to assets tax but who leases property to a person who is subject to assets tax.[45] Tax planning is still possible under this regime because some taxpayers will pay income tax, while others will pay assets tax. The latter can save tax by leasing assets from the former at no additional tax cost to the former.

d. Special Rule for Expanding Companies

Like any tax on capital, the assets tax has disincentive effects for investment. To address this concern, the Mexican law allows a taxpayer to make an irrevocable election to pay assets tax on the basis of assets as determined for the second year preceding the taxable year. This amount is adjusted for inflation. This election mitigates the disincentive effects of the tax for taxpayers making the election, but leads to some tax planning possibilities, particularly for growing companies.

A similar incentive could be provided by allowing companies to pay on the basis of the lesser of the opening or closing asset balance.

5. Exceptions for Nonproductive Periods

At certain times, assets may not generate income, for example, during construction. In response to this problem, assets tax laws often exclude assets from the tax base for specified periods of time before the generation of income. For example, in Mexico, the assets tax provides for certain periods during which no assets tax is due: (i) what the law calls the preoperative period, (ii) the first two years in which activity is begun, and (iii)

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[43]ARG IA art. 3(d).

[44]MEX ATL art. 4.

[45]MEX ATL art. 1. The liability extends only to the property leased.

the year of liquidation.[46] These exemptions can be criticized as a matter of theory: economic income can be expected to accrue even before there is cash flow.[47] However, the exception is understandable inasmuch as it matches the realization rules of the income tax and is consistent with the taxpayer's cash flow available to pay the tax. The exception complicates the assets tax, however, because it requires the determination of sometimes difficult questions of fact over which the taxpayer can exercise considerable control. Tax planning (including transfer pricing) opportunities are also created by the exemption of certain taxpayers, even if they are exempted for only a limited time.

6. Relation Between Assets Tax and Income Tax

a. Qualification for Foreign Tax Credit

Assuming that the assets tax takes the form of a minimum tax, the general principle is that the taxpayer pays the greater of the two levies. Implementation of this principle requires some care, however. To preserve the maximum foreign tax credit in the United States (or other countries with similar rules), it is desirable to structure the assets tax so that payments of income tax are creditable against it, rather than the other way around or rather than having the taxpayer pay the greater of the two amounts.[48] No foreign tax credit is allowed in the United States for the excess of the assets tax over the income tax. It is also necessary to specify how the rules for payment of estimated assets tax and income tax are coordinated.

[46]The Colombian law contains exceptions for assets affected by force majeur and assets related to enterprises in a nonproductive period. *See* COL ET § 189.

[47]*See* McLure et al., *supra* note 24, at 141.

[48]*See* Rev. Rul. 91-45, 1991-2 C.B. 336.

b. Carryovers and Carrybacks

Perhaps the most difficult question is what to do about the problem of taxpayers who switch between paying the regular income tax and paying the minimum tax. There is no reason to require a taxpayer to pay more overall tax if its actual income fluctuates from year to year instead of remaining constant. In Mexico, taxpayers are allowed to carry forward the excess of assets tax over income tax to years when they have an excess of income tax over assets tax, and to be refunded assets tax to this extent.[49] Of course, this approach is complex, especially if the amounts of tax for the years in question are changed on audit, because all the years have to be recalculated if one is changed. Nevertheless, a carryover mechanism is necessary in order to provide equity between taxpayers in similar economic positions.

The amount of assets tax carried forward is adjusted for inflation in Mexico and should be adjusted in countries that generally practice inflation adjustment.

Because the Mexican tax allows a carryforward, but not a carryback, of assets tax in excess of income tax, it does not take care of all problems involving fluctuation in income. For example, suppose that assets and income tax liability of two Mexican taxpayers *X* and *Y* are as follows:

	X	*X and Y*	*Y*
	Income Tax	Assets Tax	Income Tax
1985	80	60	60
1986	90	85	85
1987	100	89	89
1988	110	100	100
1989	50	100	96
Total	430	434	430

Taxpayer *X* pays income rather than assets tax in all years up to 1989. Suppose that in this year it suffers a drop in business because of unfavorable trade conditions. Under a three-year carryback rule (which is not available in Mexico), it could carry its excess assets tax liability of 50 back to the 3 preceding taxable years. It would obtain, therefore, a credit of 10 for 1988, 11 for 1987, and 15 for 1986, for a total of 36. Therefore, in 1989, it would pay income tax of 50 and assets tax of 14.

Compare the situation of *Y*, which has the same total income tax liability as *X*, except that it is distributed in a different pattern from year to year. Because *X* is not allowed a carryback under the rules in effect in Mexico, it is disadvantaged relative to *Y*, which has a steadier stream of taxable income.

c. Nondeductibility of Assets Tax

[49] *See* MEX ATL art. 9.

It is generally provided that the income tax itself is nondeductible for income tax purposes. Payments of the assets tax should similarly be stated to be nondeductible in determining taxable income for income tax purposes, because the assets tax serves as a minimum income tax.[50]

7. Foreign Tax Credit

Assuming that the assets tax base includes assets held abroad, it is necessary to prevent double taxation, along similar lines as double taxation is avoided under the income tax by granting a foreign tax credit. Because the assets tax is a minimum tax, the relief for double taxation must be coordinated with the allowance of a foreign tax credit under the income tax.

In Mexico, a foreign tax credit is allowed against the assets tax for foreign income taxes paid by subsidiaries of the taxpayer.[51] Foreign taxes that are paid by the taxpayer itself are in effect creditable against the assets tax in that the amount of income tax that is credited against the assets tax is the amount of income tax liability, without reduction for the foreign tax credit.[52]

8. Valuation

Valuation is the Achilles heel of the assets tax. The tax would work reasonably well if the base were the fair market value of the taxpayer's assets. But if, as is customary, the value used is the tax cost for income tax purposes, then there can be a substantial deviation from fair market value. In the case of real property, one could use the assessed value for purposes of the real property tax, but the effectiveness of doing so depends on the quality of the assessments that are made for purposes of the property tax. The practical limitations on valuing property for purposes of the presumptive tax will ordinarily result in a substantial understatement of its value. Taxpayers will complain about overvaluation but will keep silent in the case of undervaluation.

Using the valuation of property for income tax purposes favors taxpayers who can avoid realizing gains, because such realization will lead to a permanent increase in future assets tax liability. As far as the assets tax is concerned, taxpayers who hold substantially appreciated property are in an advantageous position until they sell the property.

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[50]*See* VEN ATL art. 12.

[51]MEX ATL art. 9.

[52]For example, suppose that the domestic tax rate is 50 percent, foreign income is 40, foreign tax is 20, and total income is 100. If assets tax liability is 53, then the amount of assets tax to be paid is 3 (i.e., 53 reduced by pre-credit income tax of 50), and the amount of income tax to be paid is 30 (50 reduced by the foreign tax credit of 20). If the amount of foreign tax were higher—say, 25—then the taxpayer would still pay the same amount domestically because the foreign tax credit limitation would be 20.

If the income tax is explicitly adjusted for inflation, the inflation-adjusted values can be used directly for the assets tax. Often, instead of the income tax being adjusted for inflation explicitly, ad hoc methods are used to compensate for inflation or to grant favored treatment for particular investments. Thus, inventories may be valued under the last-in-first-out (LIFO) method, and depreciable assets may be accounted for using accelerated depreciation. Such methods understate the value of the assets in question, sometimes substantially so. If these values are used for assets tax purposes, distortions will result. Conceivably, assets could be valued differently for assets tax and income tax purposes, but this would involve some complexity. Valuation is a particular problem for intangible assets (such as goodwill and the results of research and development) whose cost is expensed for income tax purposes.

9. Exemptions

If it is desired to maintain certain income tax exemptions, analogous exemptions must be provided for assets tax purposes. For example, suppose that the income from state bonds is exempt from income tax. The value of the bonds would have to be excluded from the assets tax base in order to maintain the effectiveness of the exemption.

10. Tax Planning

Tax planning opportunities have been mentioned in several contexts in discussing the assets tax. In general, because some taxpayers pay income tax rather than assets tax, others pay assets tax, and yet others are exempt from assets tax for periods of time, incentives are created for shifting property, loans, or income from one taxpayer to another (or, in some cases, from one year to another). Some possible techniques for shifting assets and loans have already been described. Income can also be shifted from taxpayers who pay income tax to taxpayers who pay assets tax via transfer pricing and other techniques (such as acceleration or deferral of payments). Indeed, it is inevitable under a minimum tax such as the assets tax that some taxpayers will pay it and some will not, so that tax planning opportunities cannot be eliminated completely, although they can be diminished by adopting an assets tax with a minimum level of exceptions. As the discussion above demonstrates, the design of an assets tax involves complex issues. No matter how the tax is designed, taxpayers can be expected to engage in transactions to minimize their tax liability. Therefore, adopting this tax increases the transactional complexity of the system. On the other hand, assuming that the tax rate is fairly low, one has to shift a lot of assets to show a significant tax savings. Given a certain level of transaction costs for tax planning techniques, the extent of tax planning can therefore be expected to be limited.

11. Assets Tax with Partial Scope

A variant on the gross assets tax is a presumptive tax based on particular assets, which supplants only a portion of the income tax base. This approach has been applied to income from immovable property, whereby instead of taxing actual income a specified percentage is applied to the value of the immovable property.[53] While the presumption may be more or less valid over the long term, it can be quite inaccurate as applied to the income of a particular year if the income from the land tends to fluctuate. This suggests that there would be advantages to structuring such a tax as an exclusive presumption, which would also have better incentive effects. Such a tax would, however, be quite crude and unfair if valuation were not accurate, nor would it correspond to the criterion of ability to pay.

D. Industry-Specific Methods for Small Businesses

Minimum taxes based on turnover or assets can be applied to all taxpayers, including large companies. When the focus is on the taxation of small businesses, a number of presumptive methods that are more tailored to specific industries have been applied in various countries. Some of these are described below; other variants exist.

1. Fixed Amounts Based on Profession or Trade

Some countries apply a minimum tax based on an individual's profession or trade.[54] To avoid serious inequity, the presumptive amounts must be set at rather low levels. They are thus ineffective in taxing higher-income professionals. Indeed, if the presumptive tax raises substantial revenue, this is a sign that there is something seriously wrong with the regular tax. Perhaps these presumptive amounts are better than nothing, however. A slightly more refined alternative is to divide taxpayers within a given industry into two or three classes based on turnover, with a fixed tax for turnover within each band.[55] Taxpayers may also be divided into categories based on the type and amount of capital equipment used in the business; for example, owners of slot machines could be taxed on a fixed amount for each machine owned.[56] A distinction is also sometimes drawn based on the number of years a person has been out of school. If the presumption is applied as an exclusive rather than as a minimum tax, it is important to specify a turnover ceiling above which it no longer applies.

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[53]This method was formerly applied in the United Kingdom. *See* Income Tax Act, 1952, 15 & 16 Geo. 6 & 1 Eliz. 2 c. 10, sec. 82 (sched. A). Under this scheme, certain rented property was taxed according to the actual rental.

[54]*See, e.g.,* ALB SBT art. 3; KAZ TC art. 138(1). *See* Lapidoth, *supra* note 2, at 33-35 for discussion of standard assessments in Ghana, which were fixed amounts for specific trades.

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

[56]*See* Lapidoth, *supra* note 2, at 34.

2. Contractual Method

The contractual method (*forfait*[57]) used in France is a presumptive method that strives for a fair degree of accuracy. For a time, the *forfait* was widely applicable in France, covering some one million individual business persons as of the 1960s,[58] although its importance has dwindled more recently. Taxpayers are eligible for the system if their annual turnover is below a specified amount. The contractual method differs from other presumptions in that its application is based on advance agreement between the taxpayer and the tax authority to base tax liability on estimated income instead of on actual income.[59] The rules for eligibility for the *forfait* and for the procedure of its application are set forth in the statute.[60] The methodology for determining taxable income for purposes of the *forfait* to be applied by tax inspectors is set out in administrative manuals and circulars.

To apply the *forfait*, the taxpayer must furnish the following information with respect to the preceding year: purchases, sales, value of closing inventory, number of employees, amount of wages paid, and number of cars owned by the taxpayer. The tax administration then calculates the *forfait*, which is supposed to be an estimate of the "income which the enterprise can normally produce." As can be seen, the information furnished by the taxpayer requires a substantial amount of record keeping and, in fact, constitutes virtually all the information needed to determine taxable income, except for general business expenses. These are furnished by the tax administration, on the basis of industry-specific estimates. Once the administration supplies its estimated income, it is then subject to agreement with the taxpayer. The agreed figure applies for two years, that is, the preceding year and the current year. It may be different for each of these years, and the figure for the second year may be extended for one or several successive one-year periods.

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

Similar approaches apply in some other countries.[61] In Belgium, the tax authorities may agree with the taxpayer on a presumptive assessment that remains valid for three

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

[58]*See* Taxation in France, *supra* note 57, at 345.

[59]*See* Lapidoth, *supra* note 2, at 89.

[60]*See* FRA CGI arts. 302 *ter,* 302 *quinquies,* 302 *sexies*, 302 *septies.*

[61]*See, e.g., Note, The Tachshiv in Other Countries,* 31 Bulletin for International Fiscal Documentation 101 (1977) (describing provisions in the tax laws of several European countries that allow the taxpayer and the tax authorities to agree on a tax assessment).

consecutive years.[62] The method is restricted to taxpayers not in a position to keep proper accounts.

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

> Since it is the local tax inspector who has authority to reach an agreement with the taxpayer, the caliber of the administration, especially the ability and honesty of the local inspector, is important to the success of the agreed income system.... In sum, the essence of the agreed income system is strong administration at the local level, with supervision at departmental and national levels.[63]

These factors suggest that the *forfait* may not be appropriate for many countries, and that careful consideration and planning should be undertaken before contemplating the introduction of such a scheme.

3. Methods Based on Turnover

Some countries tax particular types of income or income from specific industries on the basis of turnover, with presumptive deductions based on ratios developed for the industry or type of income in question.[64] This method responds to criticisms of the gross receipts method that there are different profit rates in different industries. However, it requires more research (and distinction among industries) to apply. This more finely tuned method is, however, suitable only for smaller businesses. Large companies would find it difficult to apply because they may operate in many lines of business. Their more complex structures also make it difficult to calculate an appropriate profit percentage.

4. Standard Assessment Guides

Standard assessment guides (*tachshivim* as used in Israel,[65] subsequently replaced by *tadrihim*) and similar methods are used in several other countries.[66] The *tachshiv* is

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[62] *See* BEL CIR arts. 342 § 1er, 343 § 1er.

[63] Taxation in France, *supra* note 57, at 357.

[64] For example, in France, in the case of income from the rental of immovable urban property, a deduction fixed as a specified percentage of gross receipts is allowed in lieu of an itemized deduction for depreciation, insurance expenses, and management expenses. Other expenses are, however, deductible in their actual amount. FRA CGI art. 31(I)(1)(e).

[65] The discussion here is based on Arye Lapidoth, *The Israeli Experience of Using the Tachshiv for Estimating the Taxable Income*, 31 Bulletin for International Fiscal Documentation 99 (1977). Other countries using similar methods include Spain and Turkey. The Musgrave proposal is also similar. *See* Musgrave, *supra* note 55.

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

based on various ascertainable factors, which are developed for particular industries. For example, a restaurant may be taxed on the basis of location, number of seats, and average price of items on the menu. The objective is to determine net profit. The *tachshiv* does involve an element of agreement between taxpayers and the tax authorities, but the agreement is on the *tachshiv* in general (being negotiated with industry representatives), not on its application to particular taxpayers.

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

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

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

In drafting provisions for standard assessments, it would be better to avoid the uncertain legal situation experienced by Israel and instead to provide statutory authority for their use. Because the determination of standard assessments involves considerable detail and empirical research, the details for their application cannot be contained in the statute. Taxpayers for whom the standard assessment is applicable should be specified, preferably on the basis of a turnover test along the lines of that used for VAT or for the requirement to use accrual accounting under the income tax. An important issue is whether for these taxpayers the standard assessment should be elective or mandatory. The preferable solution is to provide for mandatory use of the standard assessment for taxpayers with turnover below the threshold, but to allow the taxpayer to make an irrevocable election to use the normal accounting rules instead.

5. Taxation of Agriculture[67]

In many countries, income from agriculture is taxed on a presumptive basis if it is taxed at all.[68] The usual approach is to base the tax on the area of land and its quality. An estimate is made of the normal income that can be earned, given the productivity of that type of land, average costs of production, and the price of products. Relief may be provided for when the harvest in an area is bad. Certain activities may be excluded from presumptive taxation, and larger enterprises may be taxed on the basis of actual income.

For example, in France, farmers with a turnover of 500,000 francs or less are eligible for the presumptive basis of taxation.[69] The taxable income from agriculture is determined according to (1) the area of land that is under cultivation or could be placed under cultivation, (2) the type of crop, and (3) the region. For each region, the average profit for each type of crop is determined annually by a committee composed of representatives of the tax administration and farmers. If a natural disaster leads to crop loss in a region, then individual farmers who suffered from the calamity may apply for a reduction in tax on that basis. The basic rules for the presumptive taxation of agriculture are set forth in the statute.[70]

E. "Outward Signs" of Lifestyle

A presumptive minimum tax based on outward signs of lifestyle has operated for a long time in France. Similar systems apply in several Francophone countries of Africa as well as in some other countries.[71] In France, the presumption applies to all individuals, regardless of profession. Its application is discretionary, and the tax authorities have been instructed not to apply it when it would result in an exaggerated tax burden.[72] The presumption is based on certain outward signs of conspicuous personal consumption, which are specified in the statute. The signs of lifestyle of the taxpayer's spouse and dependents are aggregated. Not only ownership, but effective enjoyment, of items such as

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[67]*See* Ahmad & Stern, *supra* note 1, at 252–59; Richard Bird, Taxing Agricultural Land in Developing Countries 63–66, 147–50 (1974); Lapidoth, *supra* note 2, at 37–40.

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

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

[70]FRA CGI art. 64.

[71]*See, e.g.,* GIN CIDE art. 31 (rebuttable presumption based on rental value of principal and secondary residences, domestics, and automobiles). In Mali, presumptive taxation is based on rental value of principal and secondary residences and automobiles. *See* MLI CGI art. 13. In Mauritania, presumptive taxation is based on the rental value of the principal and secondary residences, domestic servants, and automobiles. *See* MRT CGI art. 105. In Togo, presumptive taxation is based on rental value of principal and secondary residence, domestic servants, automobiles, motorcycles, tourism planes, travel abroad (plane tickets), pleasure boats. *See* TGO CGI art. 124. Lesotho has recently adopted a presumptive tax based on lifestyle factors. *See* LSO IT § 16.

[72]*See* Francis Lefebvre, Documentation Pratique des Impôts Directs, Série Impôts sur le Revenu des Personnes Physiques V (Feuillet no. 2) ¶¶ 290, 300 (March 1, 1983). Francis LeFebvre, Documentation pratique - Fiscal §§ 850-1080 (July 1, 1989).

vacation homes and yachts, is taken into account; brief possession, for example, for one month or less, is usually ignored.

Under article 168 of the General Tax Code of France, the following items are taken into account: rental value of the principal residence, rental value of secondary residences, number of domestic employees, automobiles, motorcycles, pleasure boats, airplanes, horses, hunting rights, and golf club memberships. For each item, a fixed amount per unit (in the case of domestics, boats, airplanes, and horses) is taken into account or the amount spent or value of the item is multiplied by a specified figure. The total is then compared with taxable income computed under the normal methods. If the presumptive calculation exceeds the normal calculation by more than one-third in both the current year and the preceding year, then the taxpayer is taxed on the amount resulting from the presumptive calculation. The presumptive calculation only applies, however, if the result exceeds an amount specified in the statute. For items taxed according to a fixed amount that have been at the taxpayer's disposition for only part of the year a pro rata portion is taken into account, and situations involving a brief time only are ignored.[73]Impôts sur le revenu des personnes physiques V (Feuillet no. 6) ¶¶ 1130, 1140 (July 1, 1985). Francis LeFebvre, Documentation pratique—Fiscal § 4285 (July 1, 1989). If an item is attributable to the taxpayer via a dependent and if the dependent attains majority during the year, again a pro rata portion of the item is taken into account.[74] If several persons are entitled to use a particular item, the base for the item is divided proportionally among them according to their respective rights.[75]

Losses carried forward from earlier years cannot be used to reduce the presumptive taxation, but they may be carried over to subsequent years. In drafting a rule of this kind, it may be helpful to spell out this result. Losses incurred in the year of application of the presumption may be carried over to future years.[76] The treatment of losses generated in the year of application of the presumption can be resolved by providing that taxable income for the year is no less than the amount specified according to the presumption; in this case there will be no such loss.

Because the comparison was to be made between presumptive and declared income, the French courts have held that article 168 applied only in cases where the taxpayer had filed a return.[77] To avoid this result, the drafter should make application of the rule independent of whether the taxpayer has filed a return or not. The French statute was so amended in 1986. The French courts have also held that adjustments to income

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[73]*See* Francis Lefebvre, Documentation pratique des impôts directs, Série

[74]*See id.* § 1150; Francis LeFebvre, Documentation pratique—Fiscal § 4450 (July 1, 1989).

[75]See FRA CGI art. 168(1), para. 3.

[76]*See* Francis Lefebvre, Documentation pratique—Fiscal, Série impôt sur le revenu des personnes physiques V (Feuillet no. 19) §§ 10510–10590 (May 1, 1995). The situation was previously less clear. *See* Conseil d'État, July 26, 1978, 5,679 Lebon 328. *Compare* Conseil d'État Oct. 15, 1980, 16,603 Lebon 367 *with* Francis Lefebvre, Documentation pratique des impôts directs, Série impôts sur le revenu des personnes physiques V (Feuillet no. 17) ¶¶ 3660, 3670 (Mar. 1, 1983).

[77]*See* Conseil d'État Mar. 21, 1975, 85,496 Lebon 217; Conseil d'État July 2, 1975, 83,242 Lebon 397.

made by the tax authorities are not to be taken into account in determining whether the presumptive income exceeds the declared income by at least one-third.[78]

The presumption was for a long time irrebuttable in France. In 1986, article 168 was amended to allow taxpayers to challenge its application by proving that their actual income was less than their presumed income. Which approach makes sense in a particular country is a matter of judgment. If the presumption is made rebuttable, taxpayers may bring court challenges that the tax administration will not win if it does not have sufficient information about the taxpayer. If the presumption is irrebuttable, its application will be unfair in some cases. In France, this problem was dealt with by instructing tax inspectors to apply the presumption only in cases where it was justified and by requiring a senior tax inspector to approve the application of the presumption.[79]

The French system results in an increase in tax for some taxpayers, but the number of cases involved is small and has decreased over time. For example, in 1960, the French Ministry of Finance reported that this regime resulted in a tax increase for 1,300 individuals,[80] but only several dozens of cases can be reported today.

As a matter of procedure, it may be helpful to the application of the method to require taxpayers to include on their returns the necessary information to establish the presumption, and even to self-assess the resulting tax in the cases of countries with self-assessment for the income tax. The obligation to include this information on the return can be limited to taxpayers whose factors for applying the presumption exceed specified amounts, so that in practice only a small number of taxpayers would have to supply this information.[81]

In drafting provisions for such a system to apply in a particular country, consideration should be given to the consumption patterns of wealthy individuals in that country, and as to whether there are any factors of a mechanically determinable nature that can be added to the list. Possibilities include the amount of electricity consumed and the amount paid for private school tuition.[82] The whole formula for applying the presumption, including the factors to be used and the amount of income to be imputed on the basis of each factor, should be set forth in the statute. This is because, unlike with the standard assessment guides, there is no need to make a detailed analysis of different industries and to delegate this work to the tax authorities. As an illustration of a set of

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[78]*See* Conseil d'État, April 24, 1981, 9,665 Lebon 189.

[79]*See* Francis Lefebvre, *supra* note 72, at ¶ 310; Francis Lefebvre, Documentation pratique-Fiscal, Série impôt sur le revenu des personnes physiques V (Feuillet no. 16) § 8910 (July 1, 1989). The requirement relating to an approval by a senior tax inspector has been maintained after the presumption became rebuttable. *See* LPF art. R 63-1.

[80]Taxation in France, *supra* note 57, at 364 n.286.

[81]This is the rule in Lesotho. *See* LSO IT § 16. It was previously the rule in France, but the requirement to include information about the presumption on the return was eliminated. *See* Précis de fiscalité ¶ 181.

[82]*See supra* note 71 for other factors used in various African countries.

rules adopted in an African country, a description of the relevant provisions from the Income Tax Act of Lesotho is set forth in Appendix A.

F. Conclusion

Some countries make little use of presumptive methods of taxation, given that such methods inherently involve unfairness, because they involve a departure from the normal accounting methods used to determine the tax base. Taxpayers who genuinely have no income might end up having to pay tax under a presumptive method that is not rebuttable.

On the other hand, if compliance with and administration of the income tax is so uneven that the normal rules do not lead to equal treatment of taxpayers with equal income, then presumptive methods may prove attractive. Of fundamental importance is the capacity of the tax administration to handle the particular presumptive method. For example, where corruption of tax service personnel is a serious problem, then an approach along the lines of the French contractual method is a recipe for disaster. To take another case, the *tachshiv* approach, which involves detailed study and preparation, should be undertaken only if the necessary groundwork has been laid.

Attention must also be paid to how a particular presumptive method will work in practice. If taxpayers can hide the factors on which the presumption is based as easily as they can hide income, then the presumption will not be of much use. This is an empirical question, which also depends on the administrative capacity of the tax authorities, and the appropriate methods will therefore differ from country to country.

Another element to take into account in evaluating whether and how presumptive approaches should be used is that presumptions can involve the granting of a tax preference. Depending on how a presumption is determined and applied, it can result in a reduced burden for particular kinds of taxpayers. This is particularly the case where the presumption is elective, as in the case of the French contractual method. Thus, the purpose of the presumption can become the protection of a certain group of taxpayers (e.g., small business or farmers) rather than protection of revenue. In cases where the presumption is preferential, its application is often limited. For example, it may be available only for taxpayers with a turnover below a certain amount. In some cases, the availability of the presumptive method may depend on the legal form of business organization. For example, if all legal persons are required to keep books under the commercial code, then the use of presumptions may be restricted to physical persons. While this approach has some justification, it has the disadvantage of discouraging incorporation in situations where the presumptive method is advantageous to the taxpayer.[83]

As the discussion in this chapter shows, once a decision has been made to adopt a particular presumption, the design and drafting problems are the same as those for any other tax: in effect one has made a decision to impose a new tax, which involves its own

[83] *See* Lapidoth, *supra* note 2, at 93-96.

problems and which may or may not be linked with another tax (in most cases, the income tax) as a minimum tax. Purely from the point of view of complexity of statutory language, adding presumptions is not a simplification, even if it is designed to ultimately simplify administration. As with any tax, if care is not taken in drafting, problems will be experienced when the new regime is put in place.

Appendix A. Lesotho Provision on Outward Signs of Lifestyle[84]

Section 16 of the Income Tax Act of Lesotho provides an alternative method of calculating the chargeable income of those taxpayers with low reported chargeable income but visible signs of substantial wealth. Under section 16, a taxpayer's minimum chargeable income is calculated on a presumptive basis having regard to visible signs of wealth to which objective values are assigned. The indicators of wealth used in determining minimum chargeable income are air travel, electricity consumption, value of the taxpayer's principal residence, school fees, the value of a secondary residence, and the value of the taxpayer's motor vehicle.

If the chargeable income of a resident individual calculated under the normal rules is less than the minimum chargeable income calculated under section 16, then the individual's chargeable income is the minimum chargeable income.[85] This method of taxation is included in the new law in response to the low level of compliance that has been detected among some wealthy taxpayers. The provision applies automatically without any need for proving that income has been concealed.[86]

Minimum chargeable income is calculated in such a way that it does not apply to most resident individuals. For example, this section does not apply to a resident individual whose income (other than income subject to a final withholding tax such as interest) consists solely of employment or pension income.[87] The justification for this rule is that this type of income is generally difficult to hide; it simplifies the system by removing most taxpayers from the scope of the presumptive tax. In this respect, the system in Lesotho differs from that of France, where no distinction is drawn among sources of income. Further, this section does not apply to a resident in receipt of

[84]Adapted from the Explanatory Memorandum to the Income Tax Act 1993.

[85]In this respect, the scheme differs from that applicable in France: the French system takes the previous year into account and applies only if the presumptive calculation exceeds the regular calculation by more than one-third. The French rule results in additional complexity, but it responds to the situation where there is a temporary reduction in income for the taxable year (the previous year's income being high enough so that the presumption does not apply).

[86]Except that, in the case of a taxpayer who declares only employment or pension income, the tax administration must prove that the taxpayer received some income from other sources in order for the presumption to apply. The amount of this other income need not, however, be proved.

[87]Under this rule, it is possible that a taxpayer with income other than employment or pension income could escape the scheme by completely hiding such other income. It is assumed that it would be quite difficult to completely hide a substantial source of income. To apply the scheme, the tax authorities would have to prove only that the taxpayer received some income other than from employment or pensions.

employment or services income that is entitled to diplomatic or similar exemption or that is exempt under a treaty or other international agreement. In the case of a husband and wife where neither spouse is excluded under the above rules, this section applies to the spouse with the greater chargeable income calculated under the normal rules. Finally, each of the indicators of wealth is taken into account only if it exceeds the threshold prescribed in a schedule to the act.[88] Most taxpayers will not have amounts that exceed the thresholds. Even where a taxpayer does have amounts that exceed the threshold for one or more indicators of wealth, the presumptive calculation will have no effect on tax liability where it is less than the taxpayer's chargeable income calculated under the normal rules.

A taxpayer's minimum chargeable income is the sum of the amounts calculated with respect to each of the indicators of wealth. No deductions are allowed in calculating the minimum chargeable income of a taxpayer. This means, for example, that the deduction for dependents, or deduction for a loss carried forward are not taken into account in calculating minimum chargeable income.

In general, the indicators of wealth taken into account include those for the spouse and minor children. The French rule substitutes "dependents" for "minor children." Reference to minor children is a simpler rule and prevents taxpayer arguments that certain children should be excluded from the calculation because they do not qualify for the dependency allowance (e.g., if their income exceeds the specified threshold for the dependency allowance).

The first component of minimum chargeable income is the air travel amount. The air travel amount of a taxpayer is the total cost of air or sea travel of the taxpayer, the taxpayer's spouse, and the taxpayer's minor children. The air travel amount does not include travel on the taxpayer's employer's business, but does include travel on the taxpayer's own business. The air travel amount is taken into account only if it exceeds M 2,500[89] for the year of assessment, in which case the whole amount is considered.

The second component of minimum chargeable income is the electricity amount. The electricity amount is the value of electricity consumed in the taxpayer's principal residence and secondary home. If there is more than one secondary home, then the electricity amount includes the value of electricity consumed in each home. The electricity amount is determined by reference to accounts rendered for electricity consumption during the year of assessment. The electricity amount is only taken into account if it exceeds M 3,000 for the year of assessment, in which case the whole amount is considered.

The third component of minimum chargeable income is the principal-residence amount. The principal residence of a taxpayer is the residence (whether in Lesotho or

[88]This is another point of difference with the French system. Under the French system, all the factors are taken into account and added up before applying a threshold.

[89]US$0.28 = 1 loti (plural maloti; currency abbreviation, M).

elsewhere) at which the taxpayer spends most of his or her time during the year of assessment. The calculation of this amount depends on whether the principal residence is owned or rented by the taxpayer or the taxpayer's spouse. If it is owned, then the amount is the greater of the adjusted cost base of the residence or the value of the residence for the purposes of property rates. Where the residence is rented, the principal-residence amount is the greater of eight times the actual annual rental or eight times the annual fair market rental for the year of assessment. The principal-residence amount is taken into account only if it exceeds M 150,000. If it does exceed this threshold, 5 percent of the principal-residence amount is included in minimum chargeable income.

The fourth component of minimum chargeable income is the schooling amount, consisting of tuition and related fees incurred in respect of the taxpayer's minor children during the year of assessment. Related fees include, for example, the cost of books, excursions, and after-hours tutoring. The schooling amount is taken into account only if it exceeds M 1,000 per child, in which case the whole amount is included in minimum chargeable income.

The fifth component of minimum chargeable income is the secondary-home amount. The secondary home of a taxpayer is a residence (whether in Lesotho or elsewhere) available for use by the taxpayer or the taxpayer's spouse or minor children.[90] If the taxpayer has more than one secondary home, then each is taken into account under this head. The secondary-home amount is calculated in accordance with the same principles as for the calculation of the principal-residence amount and is only taken into account if it exceeds M 20,000. If it does exceed this threshold, 5 percent of the amount is included in minimum chargeable income.

The final component of minimum chargeable income is the vehicle amount. This is the value of a motor vehicle[91] or vehicles owned or used by the taxpayer, the taxpayer's spouse, or the taxpayer's minor children. It does not include, however, the value of a vehicle that is wholly used for business purposes.[92] The value of a motor vehicle is determined in accordance with tables that are to be published by the Commissioner, and is taken into account only if it exceeds M 20,000, in which case 25 percent of the amount is included in minimum chargeable income.

The application of section 16 is illustrated by the following example:

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[90]In France, a residence has been held as available for use even when it has been offered for sale and in fact is not used, *see* Conseil d'État Oct. 15, 1980, 16,605 or when the taxpayer has allowed a relative to live there. *See* Conseil d'État July 10, 1981, 21,354, *available in* LEXIS, Intlaw Library, FRPBCS File. When the taxpayer puts the residence up for rent, it is considered as being at his or her disposal until it is actually rented. *See* Conseil d'État March 29, 1978, 3,856, *available in* LEXIS, Intlaw Library, FRPBCS File.

[91]In France, only passenger automobiles are included. *See* FRA CGI art. 168. By administrative practice, automobiles older than 10 years or that no longer function are not taken into account. *See* Francis Lefebvre, Documentation pratique—Fiscal, Série impôt sur le revenu des personnes physiques V (Feuillet no. 12) § 6800 *et seq.* (July 1, 1989).

[92]A similar rule applies in France. *See* Conseil d'État, Oct. 21, 1981, 23,679, *available in* LEXIS, Intlaw Library, FRPBCS File.

Taxpayer is married with a spouse who does not derive any income and a ten year old child. The taxpayer receives a salary of M 60,000 and rental income of M 15,000, and has M 10,000 in deductions for the year of assessment (including the personal abatement). Taxpayer, therefore, under the normal rules has a chargeable income of M 65,000.

During the year of assessment, taxpayer

• spends M 10,000 in private air travel to Mauritius for his wife and child;

• consumes electricity in the family home to the value of M 2,500;

• has only one family home with an adjusted cost base of M 200,000 (this is higher than the value for the purposes of property rates);

• incurs school fees of M 15,000 for his child; and

• has a vehicle available for private use with a value of M 25,000.

Because taxpayer derives rental income in addition to his salary, he is subject to section 16. If the other income were interest, and subject to a final withholding tax, and not rental income, then section 16 would not apply.

For the purposes of calculating minimum chargeable income, taxpayer has amounts for air travel, principal residence, schooling, and vehicle. Because the value of electricity consumed is less than M 3,000 (the threshold set out in the Fifth Schedule), no electricity amount is taken into account in calculating minimum chargeable income. Taxpayer's minimum chargeable income for the year of assessment is M 40,000 (being M 10,000 + (5 percent x M 200,000) + M 15,000 + (25 percent x M 25,000)). Because this is less than the chargeable income calculated under the normal rules, section 16 does not increase taxpayer's chargeable income.