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THE TAXABLE CAPACITY, LEGAL ASSUMPTION AND BASIS OF TAXATION

Topic 3.3

The use of presumptions for determining the tax obligations

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Case study:

Topic 3.3 **THE USE OF PRESUMPTIONS FOR DETERMINING THE TAX OBLIGATIONS**

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CONTENTS: Ways of using presumptions in tax law.- Presumptions and the principle of taxable capacity.- Inductive assessment.- The struggle against evasion and the use of presumptions.

WAYS OF USING PRESUMPTIONS IN TAX LAW

Presumptions, that is, said logical process, on the basis of which, following the verification of a specific event, by applying the knowledge derived from experience, one evidences the existence of an unknown event, are commonly used in all fields of law and accordingly, are also applied in tax law.

Presumptions in taxation are used, in particular, when the unknown event, presumably considered existing in the presence of other elements, constitutes the assumption for the application of the tax obligation or, that is, the means for rendering easier the assessment, as regards its quantification.

There are two circumstances wherein the tax legislator uses presumptions:

- first of all, presumptions are used as instruments of normative technique. In these cases, the legislator, even anticipating an event as presumption for taxation **presumes** its existence every time there is a repetition of the elements of the specific case, which can be more easily determined than the event itself. As a rule, proof to the contrary (absolute presumption) is not admitted.
- more frequently, presumptions acquire importance in terms of evidence, in the sense that the determination of the tax presumption or, that is, its quantification, is facilitated by attributing **presumptive** weight to other events which, according to common experience, is in close relationship with the event to be determined.

It deals, in effect, with two fundamentally different hypotheses, because in the first case the presumption represents a legislative technique which serves to identify the very presumption of the tax, by integrating the specific tax case. In the second case, the presumption is the instrument, which is allowed by law, and through which it is possible to arrive at the unknown event, presumption for the application of the tax or for its quantification.

Examples of the use of presumptions of the first category may be found with a certain frequency in the tax legislation. Let us consider, for example, the rule whereby the income produced by partnerships is presumed to be received by the partners (and therefore, subject to taxation) in proportion to their participation in the company's capital stock (articles 5 and 9 of the Single Income Tax Text) without possibility of proof to the contrary. As regards the registration duty in

real estate transfers, accessions, pending interest are presumed to be transferred to the purchaser of the real estate, unless expressly excluded from the sale or else, it is proven through a registered act that they belong to a third party or have been transferred to the purchaser by a third party. Real estate transfers between spouses or next of kin are presumed to be donations, with the exclusion of Prof. To the contrary if the corresponding tax is lower than that due in the case of gratuitous transfer.

The purpose, which is common to the hypotheses that have been described, is to facilitate the application of a specific legal case when the evidence with respect to the subsistence of the event would imply investigations of great complexity and there would be the risk of giving way to a controversy. In those cases, therefore, the specific presumptive case acquires the rank of legal definition of the tax assumption.

Second-type presumptions or, that is, those having value at the probationary level, are characterized by the possibility of proof to the contrary (relative presumptions) and are traditionally differentiated into *simple presumptions and legal presumptions* depending on whether the probationary means is provided by law or not. Examples of legal presumptions are those provided with respect to Value Added Tax (VAT), when the taxpayer cannot prove a nontransferring destination of the goods acquired and which are not located in the places where the activity is carried out (presumption of assignment) or else, one cannot prove the holding, under a different title, of the acquisition of goods located in the same places (presumption of acquisition) (Art. 53 DPR 633/72) or else, as regards assessment derived from information concerning banking relationships of the taxpayer, when the latter cannot manage to prove having taken them into account in the assessment of income (Art. 32, section 1, paragraph 2 of DPR 600/73).

Simple presumptions are mainly important in the sphere of regulation of the assessment and the tax process, being essential for the administrative or judicial certainty as to the existence, quantification or juridical configuration of a fiscally important material event.

Simple presumptions are regulated in Art. 2729 of the Civil Code, in the section concerning the means of proof. Such rule provides that since simple presumptions have value as evidence, they must be balanced, precise and coherent.

PRESUMPTIONS AND THE PRINCIPLE OF TAXABLE CAPACITY

Traditionally, and at the level of theoretical structuring, the principle of taxable capacity states that the most equitable social criterion for distributing the tax burden among citizens is their capacity to pay taxes, deducted, from objective elements such as income, net worth or consumption.

The Italian code, like that of many other countries, has accepted said principle (Art. 53 of the Constitution), combining it with that of progressiveness of taxation, thus setting a strong limitation to taxation unrelated to elements that somehow are a manifestation of taxable capacity. We have seen how Prof. Gallo has read art. 53 in a somewhat innovative manner, and in a certain sense with less guarantees, aimed at adding within the concept of taxable capacity, the manifestations which cannot be immediately related to patrimonial entities, even though they may be economically evaluated.

In the scientific elaboration and concrete application of this principle, some definitions have been individualized which constitute a precise guide for the tax legislator:

- **safeguard of the vital minimum income**, income whose amount allows the holder mere survival cannot be taxed. The taxable capacity of these individuals does not allow the payment of taxes without compromising the taxpayer's own subsistence;
- **qualitative discrimination of income**, taxation should treat income types differently by taking into account their characteristics (real estate income and financial income) and the sacrifice the taxpayer has faced to produce them;
- **consideration of the taxpayer's personal conditions**, the personal situation (single or married, with children or without children) of the taxpayer should find the fair determination in the distribution of the tax burden because it affects the individual's taxable capacity;
- **effectiveness,** the manifestations of wealth (income, net worth, consumption) which can be taxed should be referred to truly existing and not fictitious entities, that is, they should be manifestations of effective and not ***presumptive wealth.***

At this point, it is necessary to stop on the requisite of "effectiveness" of the tax presumption and of the tax bases.

The tax legislator, on individualizing the tax presumption must ensure that it be the expression of "effective" taxable capacity and, therefore, the legal definition of the specific tax case cannot, as a rule, be based on presumptive indications of an absolute nature (which do not admit proof to the contrary) because, on doing so, also included within the manifestations of taxable capacity are hypotheses which, considered in abstract, do not constitute, or do not always constitute expression of said capacity.

Also with respect to the definition of the tax base, the profile of "effectiveness" requires that the elements that are going to be presumptively included in the tax base may find a reasonable confirmation in reality (let us consider the presumption of ownership of properties, money and jewels for purposes of the estate tax) to avoid having to resort to systems of quantification of the tax base, supported on average indexes or calculated globally. A system of taxation or, that is, of determination of the tax obligation through global indexes or estimations with some of the following characteristics can be considered harmless to the principle of taxable capacity:

- that it be based on reliable statistical analyses;
- that it tend to simplify the application of the tax;
- that it not be solved by sanctioning the taxpayer;
- that it depend on the taxpayer's free option;
- that it be limited to economic realities (small business, independent work) for which it seems logically appropriate to resort to such forms of assessment.

Precisely, the optional nature, the circumscribed application, the basis and rationality are the elements that justify resorting to said systems, safeguarding the principle of taxable capacity, under the profile of effectiveness of the tax base subject to taxation.

As a consequence, the more reliable and sophisticated the systems of presumptive assessment of the tax base, the greater their capacity to precisely quantify the tax obligations of the taxpayer and to resist, in the phase of confrontation with the taxpayer and before the tax judge, even with respect to the constitutional principle of taxable capacity.

If it is true that the application of the principle of taxable capacity, considered abstractly, provides that all manifestations of wealth be individualized, in the first place and, therefore, taxed homogeneously, it is also true that wealth appears in very diverse forms and characteristics which in a certain sense might seem a whim not to consider it. For some income (for example, income from labor in a dependency relationship), some net worth (real estate) or other types of consumption (fuel) individualization as well as taxation is easy; for others, income from independent work, financial net worth, etc.), it is much harder to tax them fiscally. The existence of difficult to tax wealth may lead to a very strong unbalance in systems, such as the Italian one which is based on voluntary compliance with tax obligations. Systems in which the instruments devoted to contrast the evasion phenomena, such as controls and sanctions, cannot achieve significant results in all sectors of economic life. When neither controls, which anyway cannot exceed a certain number, or sanctions, which cannot strike evasion in a more severe manner than other anti-juridical behaviors, succeed, there is a strong temptation to resort to systems of substitutive taxation or, that is, to forms of income assessment of an inductive-presumptive type. In these cases, it is not always easy to achieve an acceptable balance between equity of withdrawal, efficiency of the taxation system as a whole and respect for the principle of taxable capacity.

As far as Italy is concerned, the Constitutional Court has affirmed several times the legitimacy of the recourse to presumptions in taxation (ordinance n. 22 of 22-1-92) on the condition that they be reasonable, be based on indexes specifically disclosing wealth and there be the possibility for the taxpayer of objecting its basis.

INDUCTIVE ASSESSMENT

With the reform of the 70s, the use of presumptions in the filed of tax assessment has been expressly regulated. In particular, in analytical assessment, (also called accounting), there is the possibility of resorting to presumptions on the condition that these means of proof have the characteristics provided by the Civil Code or, that is, that they have the requisites of weighting, accuracy and agreement (Art. 39, paragraph 1, DPR 600/73).

In the previous system, given the scarce formal obligations of the taxpayers, the Administration was customarily allowed to resort to the so-called simple assessment for determining the tax base; which simple estimation was based, in general, on simple presumptions, not necessarily having the weighting, accuracy and agreement requisites. The reform resulted in the adoption of a system whereby, on the one hand, a series of formal obligations of a certain importance as regards, filing, accounting records, etc., are assigned to the taxpayers, as guarantee of the assessment (or, that is, of the possibility of performing an analytical assessment) and on the other, stricter and more precise rules have been established for the use, by the administration, of the presumptive evidence at the administrative and jurisdictional level.

Only when the taxpayer does not abide by the formal rules of the “game”, that is, does not duly comply with all the formal obligations (filing, accounting record) required for the assessment, can one disregard the accounting results and resort, for assessing the company’s income, to the simple presumptions widely used in the previous system. The regulation of this assessment method, commonly known as *inductive,* is included in article 55, paragraph 1, DPR 633/72 for VAT and in Art. 39, paragraph 2, DPR 600/73 for direct taxes.

In sum, the hypotheses whereby the administration is allowed to make the inductive assessment are:

- non-filing of income return by the corporation;
- failure in making available the obligatory accounting records or books;
- irregularity, inaccuracy or falsity of the accounting records of such seriousness so as to presume without grounds, the records themselves and lose the guarantees of a systematic accounting system (recently, provisions have been issued, which clarify when an accounting system may be considered “irregular”);
- failure to show documents and respond to questionnaires sent by the office.

In these cases, there is the possibility for the office to use presumptions without the requirements of weighting, accuracy and agreement for determining the pertinent amounts for tax assessment purposes (volume of business, income, etc.), thus facilitating the administration’s activity in cases where documentary control is impossible, or else, the documents clearly lack grounds.

To allow the use of simple presumptions does not imply that the presumptions used by the administration may be arbitrary (weighted), inaccurate (accurate) and contradictory (in agreement). The administration must in any case prove, in a convincing manner, the subsistence of the tax presumption or, that is, its quantification based on a logically reasoned argument or data deducted from relevant and significant factors. According to common experience, in the economic sector wherein the taxpayer operates, the level of accuracy required of the evidence is minimized. In practice, this type of assessment is based on characteristics outside the company, such as the productive capacity of the machinery, the yield from labor or else, the yield from raw materials used in the productive cycle.

The evidence of the presumptions in any case is entrusted to the office and there is no inversion of the burden of the proof.

The possibility of resorting to inductive assessment is, as we have seen, limited to some specific cases and when the administration resorts to it, the assessment does not always resist the taxpayer’s objections at the jurisdictional level. It is an instrument which may not have a generalized use, while evasion in certain sectors of the economy appears with certain evidence.

THE STRUGGLE AGAINST EVASION AND THE USE OF PRESUMPTIONS

Starting in the 80s there is a strong demand for rendering more effective the struggle against tax evasion. Such demand has been ever more perceived by the social body, inasmuch as the inequalities actually existing in the distribution of the tax burden among the various taxpayers has become more evident and the tax pressure has likewise increased. The response given by the system to satisfy this demand was aimed initially at the expansion of the accounting obligations (tax receipt, tax voucher and issuance slip) and the increase of sanctions (with the introduction of specific figures of offenses); therefore, to the increase in the number of controls (favoring partial and selective assessments) and overcoming the strict proposal of rules on assessment which indiscriminately favored the analytical accounting assessment, even in individuals for whom accounting obligations are not very urgent and broad (called individuals with simplified accounting). The need has clearly originated for separating the taxpayer sector in order to take into consideration the significant differences that characterize individuals, and to be able to use the fiscal control instruments oriented toward an objective and according to the specific characteristics of the taxpayers that are to be verified. In fact, there is no doubt that the possibilities of evasion are diverse for a large company or a small businessman and that the forms of evasion to which these individuals resort, in general, are not comparable. To think

about defeating evasion by the small business or independent work with the instruments used for the large enterprise (analytical-accounting control) has proved to be illusory upon verification of the facts. Individuals who deal directly with the public may, in fact, very easily conceal revenues, although maintaining a formally perfect accounting system. It was necessary, therefore, to resort to instruments that would allow a substantial control of the returns filed by the taxpayers, disregarding the accounting data.

The systems introduced through time to respond to the aforementioned demand are known as **presumptive coefficients, minimum tax,** the **parameter,** the **sector studies** and the **income meter**.

They are forms of assessment on a presumptive basis, considering the trend toward homogeneity of the economic results of the various productive categories and the possibility of structuring more or less sophisticated parameters that are representative thereof.

They are diverse systems that have succeeded each other in time, based on norms that frequently have been superimposed in a confusing manner and which have not always been appreciated by those who should apply them.

In general, it may be said that the first four systems had been exclusively oriented toward the control of small businesses and independent workers, while the income meter concerns all individuals subject to Individual Income Tax (IIT). We will go over them briefly to stop on the instrument of the sector studies that appears as the one to be most widely applied.

The "**presumptive coefficients "** [1], introduced in 1989 (although already anticipated for the taxpayers considered of global valuation in 1984), were indexes developed by the Ministry of Finance on the basis of extra-accounting elements, such as the surface of the premises used by the business, the amount of acquisitions of raw materials, compensations paid to the workers, machinery available to the company for carrying out its activity. These indexes were applied to each of the businesses to determine the amount of revenues and taxable operations for VAT purposes. In essence, it was a **relative legal presumption** on which basis an income above that resulting from the accounting records was determined, for individuals who could resort to simplified accounting systems. The taxpayers had in any case the possibility of rejecting its validity with all the means of proof.

Such mechanism of presumptive determination was abandoned before massive use could be made thereof and instead it has been replaced by the **"parameters"**.

Parameters are also indexes based on the characteristics and conditions in which the activity is exercised, together with the coefficients, but are differentiated from the latter in the probationary stage, inasmuch as they are not legal presumptions, as such binding for the judge, but are rather simple presumptions whose validity for determining the unknown event is submitted to the sensible appraisal by the judge.

[1] The so-called **minimum tax**, at times confused with an autonomous tax, in fact, was a control procedure which served as basis for determining and directly collecting the tax on eventual differences between declared income and inocme corresponding to the “direct labor tax”, that is, income received by whomever carried out analoguous tasks as worker in a dependency relationship.

In addition, these may be used by the taxpayers under the simplified accounting system, as well as by taxpayers under the regular accounting system, provided that the income or compensation declared does not exceed 10 billion Liras (approximately 5 billion Euros). For taxpayers under the regular accounting system, the use of the parameters is subordinated to determination of irregularities in the maintenance of the accounting records.

The parameters have originated as a provisional instrument until the entry into force of the sector studies and are, therefore, intended to be used for controlling the years of 1995, 1996 and 1997.

An instrument that may be applied to all Individual Income Taxpayers, be they holders of income from businesses, as from independent or dependent work, is the so-called **"income meter"**, that is, a system which based on the verification of possession of some properties (secondary housing, automobile, recreational boats, etc.), quantifies the necessary expenditure for their maintenance, **presuming** that such expenditure has been made on account of the taxpayer's income. In case the declared income is lower, by more than 25% to that obtained through the calculation with the "income meter" (and there are at least two tax periods), it is possible to evaluate the difference. In this case also, the taxpayer has the possibility of using all the means of proof for contradicting the treasury's claim.

Continuing on to the **sector studies,** I will limit myself to some general comments in order to allow my colleague the presentation of the technical characteristics of the studies and examples of a study already made.

The sector studies are systems for quantifying some business magnitudes (entries, store, etc.) based on statistical-mathematical methodologies and sector analysis, developed in collaboration with the interested taxpayers and the corresponding category associations.

Based on the information (it is a large amount of accounting and extra-accounting data) requested to the taxpayers by means of a special questionnaire, some income functions were structured for each taxpayer category which may perform a double function:

- directly allow the assessment when the income declared is lower to that determined through the application of the sector study, without the need for any verification activity;
- accept the assessment when the accounting records may have turned out to be irregular or groundless.

The first hypothesis may always be implemented with the companied having simplified accounting, while with respect to the companies having regular accounting through their own choice and those exercising arts or professions, the Administration may proceed to the assessment based on the specific sector study, if the income declared by the taxpayer is lower than that of the study in two of three consecutive tax periods.

The second hypothesis may be implemented with individuals that are obliged by law to maintain regular accounting records. In the case of said taxpayers, the sector study may be used by the administration only after having proven the irregularity or lack of justification of the accounting entries, following the inspection.

Sector studies are applicable to individuals with income or compensations not exceeding 10 billion Liras and not lower than 20 million Liras with a tax period equivalent to twelve months (the provisional ones, for example, are excluded).

The taxpayer showing income or compensation lower than that derived from the application of the sector study may adjust it at the income filing office, by paying the corresponding taxes without sanctions or interest and thus being left outside the scope of the administration's assessment activity. Otherwise, he must be prepared to justify, with all the means of proof, the differences found, eventually arriving at an agreement with the administration (assessment with consent), or else by objecting the assessment at court.

Sector studies afford indubitable advantages for the taxpayers as well as for the administration:

- **less discretional power** on the part of the offices and accordingly, greater certainty for the taxpayers, since the data for the assessment originate from a reliable source;
- **greater transparency** in the Treasury-taxpayer relationship, inasmuch as the data on the studies are public;
- **reliability** of the data in support of the assessments, because they originate from the analysis of almost the entire universe of individuals operating in a specific sector and are elaborated with sophisticated statistical-mathematical methodologies;
- **accuracy** of the results because the characteristics of each of the taxpayers and not average values of categories are taken into consideration;
- possibility of **increasing** the number of **controls** by jointly making them more effective;
- **improvement of the relationship with the taxpayer** since the sector studies are validated by the category associations of which the controlled taxpayers are a part.

Last, but not least, an aspect that should not be underestimated is that the sector studies may become a strong instrument of great reliability, as regards the knowledge of the country's productivity, if, as anticipated, the data are updated year after year, thus rendering possible the analyses that may support political decisions.