PATENT SYSTEM OF TAXATION FOR SMALL BUSINESS: COUNTRY EXPERIENCE OF INTRODUCING SPECIAL TAX REGIMES

Victoria IORDACHI, PhD, National Institute for Economic Research

This paper analyzes country experience of taxing small business using simplified tax regimes. The tax regulation for small entrepreneurship is one of the most important factors with a significant influence on the development of national economy. One of measures used by government to promote small business was the introduction of the patent system of taxation. At the same time, the analysis of practice of several countries in application of patent fee revealed a number of problems. This study is devoted to the analysis of patent systems in international practice, as well as alternatives in application of special tax regimes to small entrepreneurship.

Key words: *Patent tax, Tax Card System, the fixed-rate tax of low tax-bracket, Small business tax, micro-entreprise tax, presumptive taxation, small business, simplified tax regime.*

Aceată lucrare analizează experiența țărilor străine cu privire la impozitarea microîntreprinderilor prin intermediul regimurilor simplificate de impozitare. Reglementarea fiscală a micului business întotdeauna a reprezentat un factor major de influență a economiei naționale. Una din măsurile implementate de autoritățile fiscale în promovarea antreprenoriatului mic este aplicarea sistemului de impozitare în baza patentei de întreprinzător. Totodată, în urma analizei practicilor țărilor străine au fost relevate o serie de probleme în aplicarea acestui tip de impozitare. Astfel, acest studiu se dedică analizei regimurilor fiscale în baza patentei de îmtreprinzător în practica internațională, precum și alternativele implementării regimurilor speciale de impozitare pentru businessul mic.

1. Introduction

In the modern market economy, small business plays an important role as it responds for solving the problems of employment, population welfare improvement, and also contributes to the maintenance of a competitive environment. But the existence of small business, especially in transitions countries is almost impossible without the active support of the Government through state programs to promote small businesses, including the formation of tax policy to stimulate its development. Thus, international practice of applying simplified (presumptive) taxation uses a variety of approaches of taxing MSEs, but ***the general trend is offering small businesses the option to be taxed based on turnover rather than net income.*** These systems vary considerably in terms of general scope of implementation, the criteria used to determine tax liability of the company, and its revenue. Thus, there are no general principles of simplified tax regimes as there is no uniform experience with the design and implementation of presumptive systems. Nevertheless, there can be stated some general key points of applying simplified taxation system:

1. ***Presumptive taxation is the instrument for reducing the MSE compliance burden with standard recordkeeping requirements.*** The application of presumptive systems should be limited to small businesses having difficulty of keeping own books and records. Abuse of the system by larger enterprises should be excluded;
2. ***More attention should be devoted to improving the design of simplified regimes and monitoring their application.*** This will require a more profound analysis of the economic situation and the tax compliance challenges facing the small business segment, and increased efforts to improve the quality of bookkeeping;
3. ***The general scope followed by the Government should be familiarization of small companies or individual merchants with legal accounting requirements and bringing informal business into tax net, and not generation of tax revenues.*** State costs into the design of simplified tax regimes represent in fact investments in the formation of population tax culture and not instruments generating short term budget revenues;
4. There is a large variety of approaches to taxing MSEs on a presumptive basis***. The most common systems are a simple turnover tax and a tax based on business indicators***;
5. Different approaches could be chosen for different segments of the MSE sector. ***Detailed data analysis to properly estimate MSE profit potential is required***;
6. ***Presumptive systems should not act as a disincentive for business growth***. Therefore they must be coordinated with the standard tax regime.

Basically, simplified tax systems can be grouped in three categories:

- *Simple lump-sum patents*
- *Systems based on turnover or gross income*
- *Systems based on indicators*

Most regimes have changed fundamentally since their first introduction, and many regimes are modified on a regular basis. While, in the 1990s, simple fixed-tax or patent regimes were widely used for the small business segment, today, such regimes are largely limited to micro businesses or individual merchants, while a turnover-based approach has become the standard method for taxing small businesses.

2. Patent system of taxation in European countries

The characteristic of a patent regime is the application of a uniform tax on a business segment irrespective of the size or turnover generated by businessman. Regimes supposing the application of a patent are frequently administered by local governments, and revenues go to local budgets. Only in a few cases, such as in Georgia, are micro businesses exempt from income taxation. Patent fees are generally determined by local governments, while national tax laws provide the basic structure for the regime and determine minimum and maximum patent rates.

Patent systems have some advantages and disadvantages:

a) **Potential advantages generated by patent systems**:

- Tax burden is transparent and predictable for business owner
- There are no disincentives for business growth
- Estimation of potential business revenue is not required

b) **Potential disadvantages of patent systems**:

- System might be highly unfair and ignores the “ability to pay” principle
- There is a high risk of over-taxing less profitable companies.

The actual design of patent regimes varies considerably in practice. In a few countries, patent systems are extremely simple, fixing the amount for all micro businesses, irrespective of business type and location (see table 1). In Kosovo, low-income generating activities are subject to the payment of a quarterly patent of 37,50 EUR.

Table 1. Patent sums in several European countries

Country	Patent sum
Albania	25 000 ALL per year (240 USD)
Hungary	50 000 HUF per month (2600 USD per year)
Kosovo	37,5 EUR per quarter (200 USD per year)

Source: Alfons, J. Weichenrieder, Survey on the taxation of small and medium-sized entreprises. Draft report on responses of the questionnaire, OECD, 25 September 2007

Other countries practice the development of a detailed list of micro business activities and the determination of individual patent fees for each activity. A typical example of such an approach is the micro business regime in Bulgaria. Patents were initially administered by the national tax administration, but in 2008 the patent regime was transferred to local governments.

Persons that are eligible of paying the patent tax are any individual, including a sole trader[1] and are levied with annual patent tax for income from those activities, providing that:

- The turnover of the individual for the previous year does not exceed 50 000 BGN;
- The individual is not registered under the VAT Act;
- For the income from patent activities performed individuals are not levied under the procedure of the new Personal Income Tax Act.

The Law on Local Taxes and Fees of Bulgaria lists 40 different categories of activity and specifies a minimum and maximum amount per established indicator. Local governments thus determine the applicable amount for businesses in their territory, taking into consideration the precise location of the business, its economic importance, population density in the area in which the business has been established (for example, in Sofia there are four regions), and the seasonal or permanent nature of the activity carried out (see table 2).

Table 2. Activities covered by patent tax in Sofia (39 activities per total), in BGN

<table>
<tr><th>Activities in base of patent</th><th>I</th><th>II</th><th>III</th><th>IV</th></tr>
<tr><td>Collective tourist accommodation establishments or supplementary tourist accommodations of not more than 20 rooms: the tax shall be assessed per room according to the location of the establishment:</td><td colspan="4">250</td></tr>
<tr><td>Mass-catering and entertainment establishments: the tax shall be assessed per customer place, including such in the open air, or per establishment, according to the location of the establishment:</td><td colspan="4"></td></tr>
<tr><td>Restaurants
one- and two-star
three-star</td><td colspan="4">
35
60</td></tr>
<tr><td>Fast-food
one- and two-star
three-star</td><td colspan="4">
20
60</td></tr>
<tr><td>Cafes and patisseries
one- and two-star
three-star</td><td colspan="4">
20
50</td></tr>
<tr><td>Retail trade on a net selling space of the establishment not exceeding 100 square meters: the tax shall be assessed per square meter of net selling space according to the location of the establishment:</td><td colspan="4">20</td></tr>
<tr><td>Trade in, manufacture of, and services involving Articles of precious metals: the tax shall be assessed according to the location of the establishment:</td><td colspan="4">2500</td></tr>
<tr><td>Hairdresser and barber services, pet beauty parlour services: the tax shall be assessed per workplace according to the location of the establishment:</td><td>840</td><td>774</td><td>464</td><td>258</td></tr>
</table>

Sourse: Local Taxes and Fees Act of Bulgaria

[1] Annex 4 of the Local Taxes and Fees Act of Bulgaria specifies the types of licensed activities (patent activities) and the annual amount of tax payed

Elaboration of detailed lists of activities that are covered by patent is practiced in a number of other countries, but the disadvantage is that this list becomes voluminous and complicated. For example, the ***Polish Tax Card*** system and the ***Latvian patent regime*** are examples of such approaches. In the ***Kyrgyz Republic***, the patent list for the city of Bishkek includes more than 100 main categories of patent activity with an extensive list of sub-categories.

On the other hand, such an approach better aligns the patent sum with the presumed income of the micro-business, but steel, there remains a number of implementation problems. International experience shows that ***business community does not accept such a detailed patent list of activities, as they consider the process of rate setting non-transparent, while the patent amount that they have to pay as arbitrary and unfair. Also, the more detailed the activity list is, the higher the probability that a micro business carries out more than one listed activity and their tax liability is multiplicated.***

Another problem is created on behalf of Government. It is a major responsibility to set more different rates and ensure that they are properly updated and reflect changes in business environment. Usually, ***in transition countries, ministries of finance and tax administrations are not well equipped and don't possess the required personnel to perform this task adequately.***

Some patent regimes have introduced some indicators to be considered in setting patent amounts. Thus, the most popular and considered transparent indicators are the number of employees and the location of business. The example of such a system is the **Tax Card regime in Poland.** In table 3 it is shown what are the patent rates for some of micro-business activities considering these two indicators: number of employees and business location.

Table 3. Tax Card regime in Poland: monthly payment rates for some of micro-business activities, in 2014 (USD)

Type of business	No. of employees	Business location (in number of inhabitants)		
		< 5000	5000-50000	>50000
Jewelry shop	0	136	149	149
	1	232	266	266
	2	348	388	388
Barber shop (ladies)	0	38	45	51
	1	103	116	129
	2	143	161	172
	3	172	185	201
	4	185	201	218
	5	225	257	291
Flower shop	0	161-218	177-278	218-356
	1	177-281	218-356	278-406
	2	218-356	278-406	375-507

Sourse: Yulia M. Galimardanova, Aigul R. Khafizova, Svetlana Salmina, Patent System of Taxation for Small Entreprises: Analysis of Applications and Prospects

In Latvia, a physical person who wants to start business activities by purchasing a patent should register in the State Revenue Service, such an opportunity having emerged at the end of 2009. The patent payment is a fixed tax, comprising the personal income tax and the state mandatory social insurance payment, for the physical person‘s economic activity in a particular profession. The monthly payment of a patent payment is set in detailed for each group of professions and its amount varies from 30 LVL to 70 LVL (40 EUR - 100 EUR) for a calendar month. The patent payment is related to the following spheres – craft, consumer services, floristics, photography services, beauty services, private household services, home care services and gathering of forest and meadow gifts for trade.

The procedure of submitting for a physical person to register as a patent payer is simple, supposing the submission to the State Revenue Service the corresponding application, by indicating the group of professions, within which the economic activity would be performed and the period of time for which the physical person would like to make the patent payments. Even if the applicant has not gained any income from economic activity, alongside with the application there should be paid the patent amount.

According to Latvian legislation, the patent payment cannot be chosen, if the annual income from the physical person's economic activity exceeds 10000 LVL (nearly 14000 EUR) or the person has registered with the Register of VAT Payers. Also, the beneficiary of the patent must not employ other persons and perform any other economic activity at the same time.

According to accounting rules, the payers of patent payment carry out only the bookkeeping of income, but cash register systems should be used when payment in cash is received. Also, the payers of patent have the responsibility to issue a registered receipt upon the request of partner.

3. Special tax regimes in international experience

3.1. The Micro-enterprise Tax Rate in Latvia

Significant impulse for the promotion of business in activities Latvia was the introduction of *Conception on the Measures to Support Micro-Enterprises*, having the aim to create the necessary preconditions in order to encourage the unemployed to start the business activities and develop the business environment. As a result of conception there was adopted a completely new law – The Micro-Enterprise Tax Law, and since September 1, 2010, the enterprises may apply for obtaining ***the micro-enterprise tax payer‘s status***. In compliance with this law, a micro-enterprise is an individual merchant, an individual undertaking, a farm or fishing enterprise, as well as a self-employed person registered as a performer of economic activity at the State Revenue Service, or a limited liability company.

The micro-enterprise tax rate is 9% of the turnover or the income from economic activity and comprises the state mandatory social insurance payment, the personal income tax and the state duty on the entrepreneurship risk for the employees of a micro-enterprise, as well as the corporate income tax. If the turnover of a micro-enterprise is in the amount of 7000,01 to 100 000 EUR, then the rate is 12 %, starting with the fourth year of economic activity since the acquisition of a micro-enterprise taxpayer status. Accordingly, if the yearly turnover of a micro-enterprise exceeds 100 000 EUR, the tax rate is increased till 20 % levied on the exceeding part.

As a tax payer the micro-enterprise should meet the following criteria:

- the revenue from economic activity (turnover) shall not exceed 100 000 EUR in a calendar year;
- the number of employees for the micro-enterprise at any given moment shall not exceed 5 persons;
- the revenue of a micro-enterprise employee shall not exceed 720 EUR per month;
- the shareholders are natural persons;
- members of the board are only employees (owners, shareholders and natural persons in employment relationships) of the micro-enterprise;
- the micro-enterprise is not a member of a partnership.

Starting from 1st January 2017 the micro-enterprise tax for enterprises with turnover up to 7000 EUR will be 5 %, for enterprises with a turnover from 7000,01 to 100 000 EUR for the first three years – 5 %, but starting from the fourth year – 8 %. Also, an important change is that the State social insurance mandatory contributions will not be included in the micro-enterprise tax. Therefore the State social insurance mandatory contributions will have to be paid separately (in addition to the micro-enterprise tax) in the amount of the minimal State social insurance mandatory contribution.

3.2. The Simplified Tax Regime in Hungary

Small companies in Hungary benefit from a favorable tax system since 2013 in form of the fixed-rate tax of low tax-bracket enterprises (KATA) and the Small Company Tax (KIVA) (Figure 1).

KATA is one of the simplest taxation forms, because the fixed contribution redeems the corporate income tax, the personal income tax, the social contribution tax, the contribution to qualification fund, the health care contribution and the contributions to be paid by the individual. The total monthly amount of this tax is 50 000 HUF as a full time fix-rate taxpayer. If he wants to have a higher amount of social insurance, there is an option to choose a larger tax – 75 000 HUF. As a non-full time fixed-rate taxpayer, the tax will be 25 000 HUF per month.

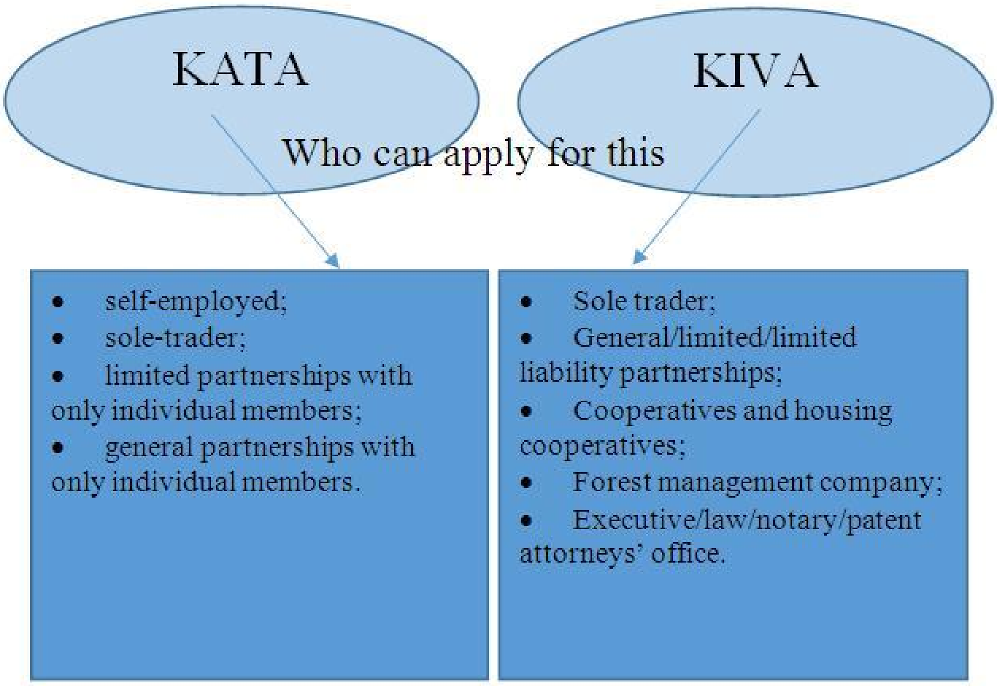

Fig. 1. Simplified tax regime in Hungary

Source: Made by author in base of Data base National Tax and Customs Administration of Hungary, available at http://en.nav.gov.hu/

If the income of the fixed-rate tax of low tax-bracket enterprise exceeds 6 million HUF in one calendar year, the amount beyond that limit has a 40% tax duty over the otherwise payable fixed monthly contribution.

KIVA as form of taxation is based on cash flow, so the tax base of the company is the cash approach result. The tax rate is 16% and the company is exempted from the following tax types:

- Corporate income tax (10%/19%);
- Social contribution tax (27%);
- Contribution to qualification fund (1,5%).

The conditions for applying for this type of tax are:

- During the year before opt for this taxation type the average number of employee cannot exceed 25;
- The total revenue and the balance sheet of the prior year does not exceed 500 million HUF;
- The balance sheet date is the 31st of December and the financials is prepared in HUF;
- During the preceding two years of the application of taxation according to KIVA, the VAT number of the taxpayer enterprise was not suspended by final decision or cancelled by the tax authority.

If the income gained exceeds 500 million HUF in the year before the taxation year, then the small company taxpayer status expires by the last day of the previous month before exceeding the threshold.

As disadvantages for applying for KIVA can be mentioned that this method requires a complex accounting and legal knowledge. Also, the cash flow result can be hardly preplanned.

3.3. Tax system based on turnover

Turnover or gross income based systems are the most popular type of presumptive tax systems. It can be applied as an exclusive way of taxing income through a minimum tax or as a forfeit. Turnover-based presumptive systems offer a number of important advantages:

- The tax burden can be reduced for periods with low volume of business transactions;
- In spite of the fact that at least some basic books and records are obliged, these requirements are not burdensome for small business operators;
- This method facilitates the transitions from the simplified to the standard tax regime;
- Tax burden calculation is simple.

Tax systems based on turnover offer a good possibility of providing specific incentives for improving recordkeeping standards. Table 4 illustrates a good example of such an approach in Tanzania.

Table 4. Presumptive income taxation in Tanzania

Annual turnover (in TZSh)	Tax payable in case taxpayer only keeps rudimentary records	Tax payable in case taxpayer keeps complete records for business transactions
< 3 million	35000 TShs	1,1% of turnover
3-7 million	95000 TShs	33000 TShs plus 1,3% of the turnover exceeding 3 million TShs
7-14 million	291 TShs	85000 TShs plus 2,5% of the turnover exceeding 7 million TShs
14-20 million	520 TShs	260000 TShs plus 3,3% of the turnover exceeding 14 million TShs

Source: International finance corporation, Designing a tax system for micro and small businesses: Guide for practitioners, IFC, The World Bank Group, December 2007

The system seems attractive, as it both introduces a progressive feature of presumptive small business taxation, and provides incentives for improving recordkeeping. A disadvantage, however, is the potential difficulty in determining the turnover of a small business that does not keep any books and records.

In some countries turnover elements have been introduced to create a progressive patent regime. In Croatia, for example, the lump sum tax amount depends on the level of the micro business turnover. The micro business in this case is still required to maintain a cash book and calculate its annual turnover. Table 5 summarizes how the turnover tax is applied from different business turnover.

Table 5. Calculating micro-business tax liability in Croatia (in HRK)

Business turnover	Tax liability
< 85000 (14900 USD)	12750 (2230 USD)
85000-115000 (20100 USD)	17250 (3000 USD)
115000-149000 (26000 USD)	22425 (3920 USD)

Source: M. Engelschalk, J. Loeprick, The taxation of micro and small business in transition economies: Country experience of the introduction of special tax regimes

Turnover-based systems incur a high risk of evasion and it can be really hard for the tax administration to detect cases of under-declaration and check if turnover data is declared honestly. Thus, there are known some practices of reducing the risk of under-declaration of business turnover:

1) Compulsory introduction of cash registers to facilitate turnover declaration.
2) Introduction of incentives for issuing receipts by means of tax invoice lotteries.

3) Promotion of credit card use[1].
4) Obligation to use financial system of payments.

3.4. Tax system based on indicators

The main alternative to a turnover-based system is a presumptive tax system based on external indicators. The main objective on behalf of tax administration bodies is to select the “proper” indicators. Thus, international practice recommends:

- Indicators should be easy checked and recorded;
- Indicators should have a low risk of falsification and substitution;
- Indicators should show a sufficient and stable correlation to actual income.

Most common indicators are the number of employees, value of inventory, capacity of machinery, and number of years of operation of the business. Also, there can be used data about business inputs from third parties, like data about electricity and water consumption. Table 6 shows an example of calculating taxable income in case of Spanish restaurant operated by owner with one salaried employee, energy consumption of 100 KW and one piece of machinery type.

The annual taxable income in the Spanish case is the total of presumed income per unit. A restaurant operated by the owner with one salaried employee, energy consumption of 100 KW and one piece of machinery type B.

Table 6. Taxation of restaurants in Spain using indicator-based system

Indicator	**Unit**	**Annual income per unit (in EUR)**
Salaried employees	Person	3,438
Non-salaried person	Person	15,434
Energy consumption	Kw	192
Equipment type A	Piece	1028
Equipment type B	Piece	3636
Total presumed income	**41709**	
Tax burden (25% tax rate)	**10427**	

Source: International finance corporation, Designing a tax system for micro and small businesses: Guide for practitioners, IFC, The World Bank Group, December 2007

The example shown in table 6 demonstrates that the system may have a very different impact on the marginal tax rate depending on the actual change of indicators, thus affecting business extension, or with respect to employment generation or capital usage, as firms will limit their use of inputs in order to reduce their overall tax liability. Practice also shows that these systems are difficult to design as it is difficult to define indicators that sufficiently reflect the profit potential and a small business owner’s ability to pay.

Also, the profit potential of comparable businesses with identical indicators considerably depends on the business location. Therefore, some countries introduce an additional factor of quality of business location, which makes the system nontransparent and complicated.

Indicator-based system should not be the prime option for the design of a presumptive tax system. It should be limited to a small number of business segments with a particularly high risk of under-declaration of turnover.

4. Conclusions

- Tax simplification should be applied for the support of micro-business sector that is burdened with excessive regulation, bureaucracy and unproductive costs. However, the major objective of simplification on behalf of tax administration authorities should not consist in generating additional budget revenues, but increasing the tax culture of population for facilitating their transition from informal to formal economy.
- The design of a small business tax system should be based on a solid data analysis. Basing tax system design on a reliable data analysis will increase the fairness of the system and promote the broad acceptance of the system among business community. Policy makers should consider the segmentation of business community and, thus, treat each sub-group with different proper policies.
- For micro businesses above the subsistence level (mainly owner-operated small businesses in the retail sector), a simple lump-sum patent generally is the most cost-efficient approach. The patent approach also reduces corruption and harassment risks. On the other hand, for small businesses above the micro level, several alternative approaches to presumptive taxation can be used: turnover-based systems; systems based on objective business indicators; and agreed systems. For reasons of accuracy, transparency, and coordination with the standard tax regime, turnover based systems generally should be preferred over indicator based or agreed systems.
- In international experience patent tax is not clearly defined in national legislation. Usually, alternatives are in form of license taxes, annual revenue norms, while payment sums are regulated by the Law on Local Taxes and Fees, or can be stipulated within national regulations on natural persons’ income. At the same time, local tax authorities

[1] In 1999 the Korean Government decided to encourage people to use credit cards. Thus, 20% of credit card expenditures could be deducted from the credit card user’s taxable income.

always adjust activities covered by patent tax, application conditions, as well as patent cost according to conditions of regions' development in which a business entity is established.

- Nearly all legislative adjustments in way of establishing tax base, differentiation of tax rates per regions, as well as conditions of applying for patent payment status proved lack of clear direction and vision on behalf of tax authorities, a critical objective still remaining the risk of system abuse by large profitable companies.

BIBLIOGRAPHY

1. Alfons, J. Weichenrieder, Survey on the taxation of small and medium-sized entreprises. Draft report on responses of the questionnaire, OECD, 25 September 2007
2. Income Taxes on Natural Persons Act of Bulgaria, available at http://www.bulgaria-tax-law.bg/income-taxes-natural-persons-act.html
3. International finance corporation, Designing a tax system for micro and small businesses: Guide for practitioners, IFC, The World Bank Group, December 2007
4. Local Taxes and Fees Act of Bulgaria, State Gazette No. 117/10.12.1997, in force as of 01.01.1998; Last Amendment - SG No. 102/ 21.12.2012, in force as of 01.01.2013
5. M. Engelschalk, J. Loeprick, The taxation of micro and small business in transition economies: Country experience of the introduction of special tax regimes, available at http://jota.website/article/view/73
6. Yulia, M. Galimardanova, Aigul R. Khafizova, Svetlana Salmina, Patent System of Taxation for Small Entreprises: Analysis of Applications and Prospects, The Social Sciences 10(6): 1080-1083, 2015
7. Baza de date a Serviciului de Stat al Veniturilor din RepublicaLetonă, https://www.vid.gov.lv/default.aspx?tabid=8&id=5831&hl=2
8. Baza de date a Administrației Naționale Fiscale și Vamale a Ungariei, http://en.nav.gov.hu/