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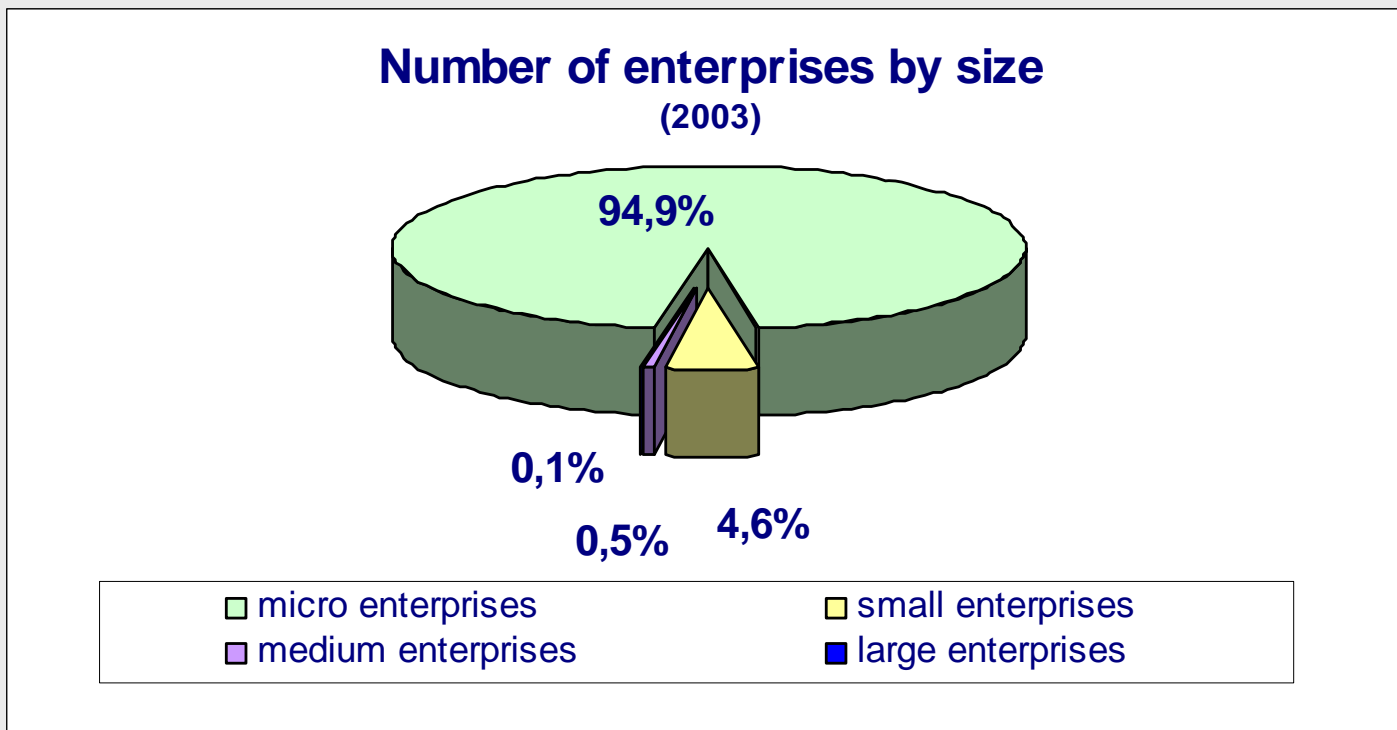
SMEs taxation in Italy the "Sector Studies approach"

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Main issues

- The role of SMEs in the Italian economy
- Implications for tax compliance
- Sector Studies as an assessment tool
- The design and set up of Sector Studies
- Conclusions

The role of SMEs in the Italian economy

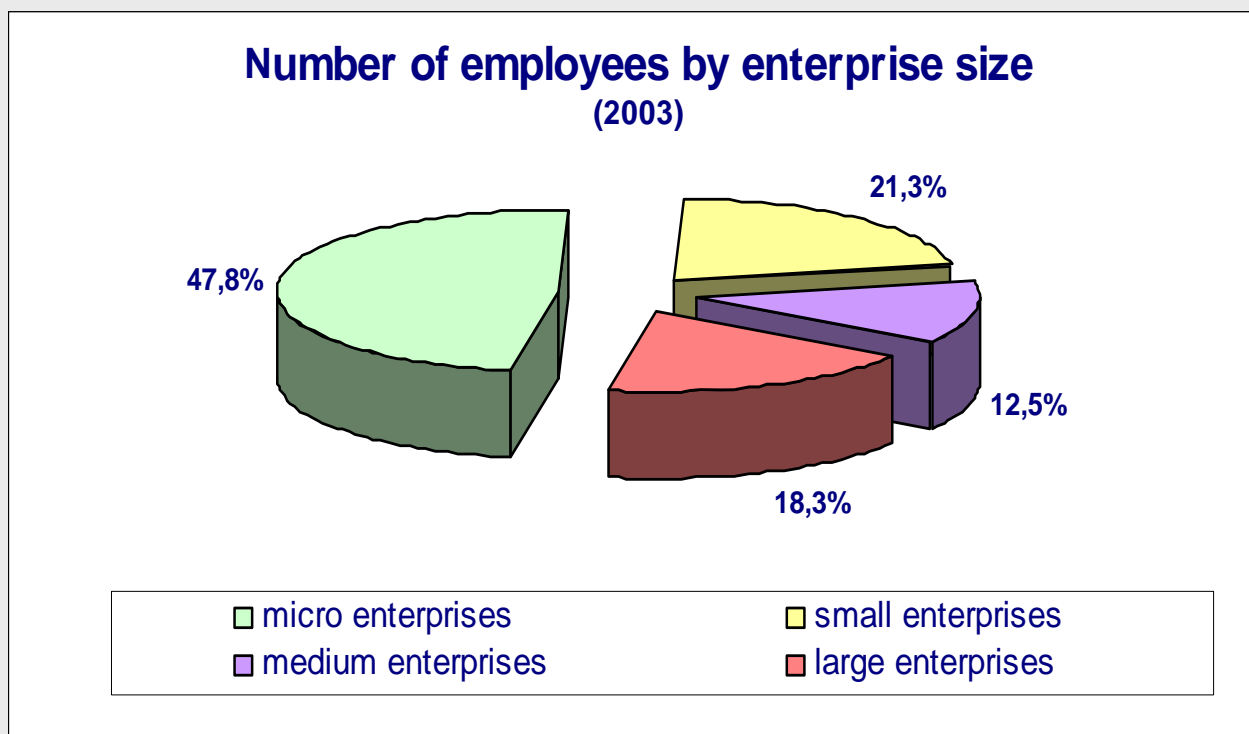


1-9 employees - Micro enterprises;
50-249 employees - Medium enterprises;

10-49 employees - Small enterprises;
More than 249 employees - Large enterprises

Source: Italian National Institute for Statistics

The role of SMEs in the Italian economy



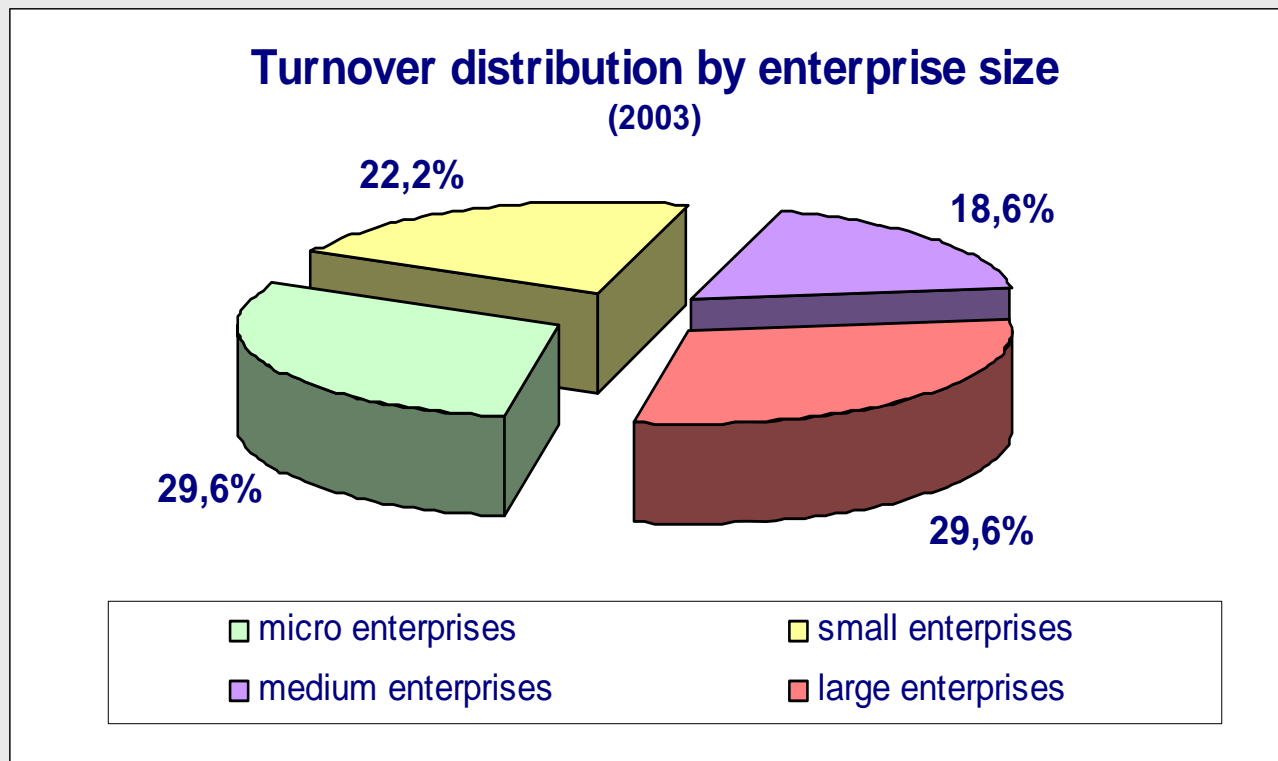
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The role of SMEs in the Italian economy



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The role of SMEs in the Italian economy: the distribution by activity sector

Activity sectors	Size				
	Micro	Small	Medium	Large	Total
Industry	82,8%	15,0%	2,0%	0,3%	100,0%
Construction	94,8%	4,9%	0,2%	0,0%	100,0%
Hotel, wholesale and retail trade	96,8%	3,0%	0,2%	0,0%	100,0%
Other services	97,2%	2,3%	0,4%	0,1%	100,0%
Total	94,9%	4,5%	0,5%	0,1%	100,0%

Source: Italian National Institute for Statistics

The role of SMEs in the Italian economy

- According to a definition of enterprise size based on the number of employees, 94% of Italian businesses are micro-enterprises.
- They account for the highest employment percentage (48%) and of turnover (equivalent to that of large enterprises).
- Micro-enterprises are the most widespread type of business in all macro-sectors. The highest percentages are in the services and trade sectors.

The rationale for sector studies

- Need to manage a huge number of small enterprises and self-employed workers in the process of tax assessment
- High costs and ineffectiveness of mass assessment
- If SMEs perceive a low risk of tax assessment and, at the same time, face high compliance costs (also due to the complexity of tax rules) they may have an incentive to evade;
- Thus, the need to design a tax assessment method targeted to both deter tax evasion and encourage taxpayers voluntary compliance.

The sector studies' solution

- By focusing on selected taxpayers displaying an “anomalous” behavior, Sector Studies allow for reducing the cost and improving the effectiveness of tax assessment. They apply to businesses with turnover under 7.5 million euros;
- The selection is made through the identification of a “normal turnover”.
- This is obtained from the analysis of the general conditions of profitability of the single business in a given economic context (sector, location, costs composition) and its comparison with the actual turnover resulting from the tax self-assessment.

Sector studies as a tax compliance tool

- By using a software provided by the Tax Administration, the taxpayer calculates the normal turnover referred to his activity and is informed about the rules applied for tax assessment in the case of a divergence of actual from normal turnover
- The incentive to comply and, at the same time, the deterring effect, result from the awareness that, in case of actual turnover below normal values, the probability of being audited is significantly high

The normal turnover calculation

Sector Studies uses a statistical methodology based on structural variables and variables reported by taxpayers for determining the normal turnover.

An econometric function enables to estimate the “normal” level of turnover to be compared with the turnover declared.

The Sector studies reference parameters

Two basic parameters

- **Congruence:** in order to be considered congruous with reference to the activity carried out, the turnover reported in the balance sheet must be higher or equal to the turnover estimated by the econometric function mentioned above;
- **Coherence:** a specific set of indicators, typical of the business, must lie within prescribed limits.

Congruence does not imply coherence and vice versa.

Congruence

- This is the most significant indicator for assessment purposes.
- If the turnover based on accounting data is lower than that calculated on the basis of the sector study, the taxpayer is automatically included in the list of taxpayers to be assessed by the Tax Administration.

Coherence

- Coherence is an indicator of “economic normality”; deviations do not necessarily lead to assessment;
- If the taxpayer reports incoherent data compared with the economic parameters, the Tax Administration may check whether such incoherence depends on poor productivity or improper tax behavior.

Process of approval of sector studies

- Definition (in co-operation with industry associations), sending out and collection of questionnaires;
- Construction of the Sector Study (definition of the turnover function and presentation to the industry associations);
- Validation (verification by a committee of experts) and publication;
- Monitoring (analysis of trends of national economy, of the market and of innovations of productive processes);

Usefulness for taxpayers

- By providing a profitability benchmark of individual economic sectors and local business “environments”, sector Studies provide entrepreneurs with useful information

Taxpayers involved in sector studies

Taxable period	N. of sector studies in force	Economic activities involved (Atecofin number 2004)	N. of taxpayers potentially involved	N. of taxpayers running business activities for which no sector study is available	Total taxpayers
1998	45	87	1.442.351	3.736.799	5.179.150
1999	86	156	2.128.336	3.041.430	5.169.766
2000	129	286	3.023.068	2.136.405	5.159.473
2001	168	386	3.786.079	1.366.416	5.152.495
2002	202	461	4.197.813	949.794	5.147.607
2003	228	551	4.424.498	716.920	5.141.418
2004	206	555	4.440.108	701.277	5.141.385

Source: Italian Revenue Agency

Conclusions

- An instrument defining the “normal” profitability conditions for SMEs seems to be the most adequate choice to manage the overall pool of taxpayers and to combat evasion
- In terms of effectiveness, the experience of the last few years has shown that, in order to adequately represent the economic environment of reference, Sector Studies require frequent updating.

Improvements:

- o Introduction of new indicators of economic normality (a mixed indicator of congruence and coherence);
- o reduction of the study's updating period from 4 to 3 years;
- o significant raising of the size threshold.