Taxation – Lecture 7

INDIRECT TAX SYSTEM:
VALUE ADDED TAX (VAT)
(EVIDENCE FROM THE CZECH REPUBLIC)

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VAT – adoption of VAT

- **Value-added tax (VAT) is still a relatively new tax.** It was first introduced as a comprehensive national tax 40 years ago in France. Since then**, it has been adopted as the main form of indirect taxation by many countries in different parts of the world and at different stages of economic development.** In particular, **it is a key common form of taxation for the 28 member states of the European Union**. It has also been adopted by Japan, China, Canada, Korea, and many other states in Asia, North and South America, and Africa, besides being adopted in almost all the states of Europe and of the former Soviet Union. Further, the process of expansion of the European Union, together with the alignment of the laws of potential candidates for membership, has ensured increasing consistency in the form of VAT operating in Europe. Of the major economies, only the United States and Australia do not have a VAT at the federal level (partly because of problems in introducing the tax in federal states), although both have considered in detail how it might be implemented.

VAT – adoption of VAT

- As a result of this rapid and widespread adoption of a VAT**, the laws implementing the tax have adopted different terms and forms in different states.** Tait has rightly described it as **an "unparalleled tax phenomenon."** There has therefore been little chance to evolve a settled vocabulary or considered common approach. In particular, **there is no international organization with the specific role of supervising the operation of value-added taxes among states** in the way that the OECD Fiscal Affairs Committee keeps an eye on double taxation agreements and the International Customs Union (formerly Customs Cooperation Council) coordinates the collection of customs duties. Although the European Commission performs that function within the European Union, and assists elsewhere in Europe, it does not have competence to act globally. Nonetheless, **despite varying names and terminology, the VAT has a common core form throughout the world.**

VAT - economic scope

- **The unique nature of the VAT is its potential scope in identifying and taxing the economic contribution - or added value - made by any economic operator in connection with any activity of a business or commercial nature**. The formal principles of this method are set out in the EC First VAT Directive as follows:

  "The principle of the common system of value added tax involves the ***application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services, whatever the number of transactions that take place in the production and distribution process before the stage at which tax is charged.***

  On each transaction, value added tax, calculated on the price of the goods or services at the rate applicable to such goods or services, ***shall be chargeable after deduction of the amount of value added tax borne directly by the various cost components****."*

VAT - territorial scope

- Because the VAT is an indirect tax focusing on the transaction or activity rather than on the economic operator, **the primary determination of the territorial scope of the charge to VAT is by reference to the location of a transaction.** If the transaction occurs within the state, then it is within the charge to VAT.
- **There are two conflicting principles on which the territorial scope of a VAT can be based**: **the origin principle** and the **destination principle**. As these names suggest, **the origin principle charges a transaction, only part of which occurs within the jurisdiction, if the transaction originates or is created within the state, and the destination principle charges the transaction if it is destined for consumption in the state**. For example, if goods are exported from state A to state B, then state A will charge the transaction if it has an origin-based VAT, and state B will charge if it has a destination-based VAT. **For services, it may in practice be harder to determine where the service is provided**, **or where it is**

VAT - territorial scope

consumed. Subject to that practical problem, an origin-based tax will concentrate on **the state of origin of the person supplying the service, while a destination-based tax will charge supplies consumed in the state.**

- **Potential problems of double taxation and absence of taxation arise if these rules clash**. For example, assume state A has an origin-based VAT and state B has a destination-based VAT. **Exports from state A to state B will be taxed in both states. Exports from state B to state A will not be taxed in either state. The result, in a free market, would be that goods from state A would be too expensive to be competitive in the market in state B, so only limited exports would occur. However, there would potentially be high levels of exports from state B to state A because the goods imported from state B would be tax free, while locally made goods in state A would be subject to tax**. In practice, state A could not afford this imbalance and would impose a charge on the goods from state B - in other words, a destination-based charge, unless the

VAT - territorial scope

charge is to be a discriminatory border charge. This would avoid the absence of a VAT, but not the double taxation.

- **To avoid double taxation, states that impose a VAT on imports remove exports from the charge to tax** (and conversely, they should exempt imports where exports are taxed). **This will also remove double taxation if both states have the same system (whether the origin system or the destination system). The example shows that those sets of rules cannot in themselves deal with a situation where the two states have different approaches to this question.**
- **There is no international agreement determining either that states should follow one of these principles rather than the other or seeking to reach common rules to avoid double taxation (or double exemption from taxation). There is, therefore, no commonly agreed set of answers to these issues.**

VAT - territorial scope

- In practice, however, and with limited exceptions, **states have adopted the destination basis as the primary basis.** There are some cases where, within a customs union or trading bloc, the origin base is used or has been proposed for adoption, but these practices are limited exceptions to the general approach.

VAT – internal charge of VAT

- **The common pattern of an invoice-based VAT is that a charge to VAT is imposed on all transactions within the state and within the scope of the VAT**. **Each taxable person is allowed a deduction against the total VAT charged by the person to take account of any VAT paid by the person on inputs related to transactions within the scope of the VAT.**
- A transaction within the scope of VAT and on which VAT is imposed is commonly called **an output and the VAT collected on it is called output tax.** A transaction made to the person making the output is known as **an input**, and the VAT paid by that person when obtaining the input is **an input tax. The internal charge to tax**, consistent with the principles noted above, is therefore **a charge amounting to the output tax received by a person less the input tax paid by that person**. The charge to tax must therefore identify on which outputs, and by which persons, output tax must be collected, and what input tax is available as a deduction against that output tax.

VAT – internal charge of VAT

- The normal approach is to impose output tax on transactions and persons if:

    (a) the transactions are "supplies of goods and services;”

    (b) those supplies are "taxable" and not exempt from VAT;

    (c) those taxable supplies are made by a "taxable person," that is, a person within the scope of the charge to VAT; and

    (d) the taxable person makes those supplies as part of the person's business activities, and not as part of a hobby or noncommercial activity.

VAT – approach to charging VAT on imports

- **States have normally adopted the practice of treating imports of goods separately from imports of services. Imports of goods are identified by the physical entry of the goods**. Services cannot be identified in this way. Instead, states have chosen to adopt rules that **treat a supply of a service as occurring within a state if the supply meets certain criteria** (and not so occurring if it does not). In this way, states have usually avoided the concept of "import of services" by defining or deeming services to be supplied either in the state or outside it (and not "to" it).
- **Principle of nondiscrimination** - **the products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products.**

VAT – taxable persons

- **A person within the scope of VAT is usually described as a taxable person. A VAT law should include all legal persons created under the law of the state (or of a foreign country) that engage in economic activities of any kind, as well as all physical persons**. The text should be drafted to bring all legal and physical persons potentially within the category of "taxable persons." It may usefully refer to the precise laws of the state under which such persons or entities derive their juridical status.
- **One problem arising here is whether the law should include partnerships and associations as taxable persons**. The extent to which associations and partnerships have juridical personality separate from the individuals who are its members varies from one state to another, and the law may need to reflect this.
- **A VAT law does not usually need to expressly mention foreign legal persons, that is, persons that derive their legal personality from the law of some other state, as with a company registered**

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in a foreign state. However, it is intended that all legal persons be registered for VAT if they conduct within the state activities of the kind and level defined in the law. In practical terms, this means that some branches or permanent establishments are required to apply to be registered, while others are found, following the jurisdictional rules of the state, not to be making supplies of the required level within the state. This problem has some similarities to that of deciding whether a person is a resident for income tax purposes. In most states, for example, a foreign company becomes "resident" and, therefore, within the jurisdiction of the state if it establishes a branch, agency, or permanent establishment within the state. There is an agreed definition of "permanent establishment" in article 5 of the OECD Model Tax Convention. A similar approach could be adopted for the VAT.

VAT – taxable persons

- **Most states require only some of the many persons active in business within the state to be taxable persons. This is normally achieved by setting a minimum level or threshold of business activity and requiring only those persons with levels of activity above the minimum to be taxable persons**. Those with levels of activity below that level are not required to be taxable persons, although they are often given the right to voluntarily choose to be taxable persons. **The usual measure of business activity is the total turnover of taxable goods and services supplied by the person over a set period**.
- **The total to be taken into account for the threshold is the total taxable supplies of that person**. This means the total of all supplies made by that person that are treated as taxable supplies within the definition of the law. **The total does not include supplies exempted from VAT or outside the scope of VAT**. **This means that a person conducting a business that is largely exempt is outside the**

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scope of the registration provisions if the taxable activities reach a total less than the threshold, although the total economic activity of the business is high.

- **The precise level of threshold varies widely from one state to another and, within a state, varies from one time to another.** There are several reasons for this. **Limits vary partly as a reflection of the economic structure of a state**. Some states have a comparatively greater number of marginal small businesses involving one person or one family than other states. Even taking account of the differences, in many states self-employed individuals or single families engaged, for example, in subsistence farming or small market trading will contribute little to the collection of VAT. It is also administratively difficult - and therefore expensive - to collect tax from such people. In addition, the exclusion of smaller traders from VAT through the use of a threshold limit is particularly useful at the introduction of the tax, when there are limits on available

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administrative resources and taxpayer knowledge of the tax is at a minimum.

- **The law may be drafted to allow the authorities to alter the amount set from time to time, both to ensure that the tax is working properly and, in any event, to ensure that inflation does not have too significant an effect on the practical level of the threshold as the minimum monthly or annual wage. The threshold then adjusts automatically with that factor.**
- **To administer the VAT, it is standard practice to establish a formal state register of those who are registered persons**. There must then be a requirement that any person who is, or should be, a taxable person take the necessary action to seek to be registered for the VAT. The law or regulations need to confirm the register and give it official status. Penalties will also be needed to ensure that all those required to do so apply to be registered. Recognizing this requirement, laws sometimes refer to taxable persons as "registered persons" or "persons required to register.

VAT – taxable persons

- **States sometimes decide to adopt and adapt an existing register, such as the register for companies or a general register of taxpayers, to act as the VAT register**. That is for a state to decide, but the register must be capable of generating a unique VAT number for each taxable person, as well as providing the tax authorities with an up-to-date list of those, and only those, who are taxable persons. For reasons of good administration, states with more limited administrative resources find it increasingly attractive that the VAT number be the same as the taxpayer identification number used for income and other taxes. The practice must meet the need to provide all those registered for VAT, whether or not they are income tax payers, with a unique number at the time they are registered for VAT.
- **Once a taxable person has been issued a VAT registration number or has had the registration confirmed under a given number, the law should require the person to use that number on**

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all official communications. For example, the number should be indicated on all communications with the tax authorities and perhaps other documents, such as official orders or official stationery.

- **States often allow those who are not required to be registered (because their activities are below the level of the threshold) to register voluntarily**. This may be appropriate for many organizations that intend to have a large turnover, but have not yet reached it; incur large expenditure in one year, expecting the income in the next year; or are carrying out business activities at a level that does not reach the registration limit, but that do not wish this information to be known by customers (e.g., younger self-employed providers of services). **Voluntary registration also allows those operating just below the threshold level to avoid any competitive disadvantage compared with other operators who are required to be registered.**

VAT – taxable persons

- **There is sometimes a danger to the integrity of a tax system in allowing uncontrolled voluntary registration.** First, this may allow those who are not in reality engaged in business to register with a view to claiming rebates of input tax when they have no real intention of paying much output tax. Such persons should not be entitled to register unless they are genuinely involved in business, but both practical and legal safeguards are needed to ensure that the tax authorities can control this situation. Failure to control it may result in significant revenue loss. It may be deterred to some extent by placing a minimum period on voluntary registration, as noted below.
- **Provided that the tax authorities can ensure that the integrity of the VAT is safeguarded, economic neutrality will be achieved only if voluntary registration is allowed. A compromise adopted by some states introducing a VAT is to set a minimum activity level for compulsory registration and a lower minimum level for voluntary registration.** Where these rules operate, a person can

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register voluntarily only if the lower minimum is met. **This excludes those persons with no real economic activity or whose businesses have not yet started.** At the same time, it allows some voluntary registration to control distortions between those just above and those just below the compulsory threshold.

- **The law should provide for three situations where VAT registration should be canceled:**
    - **The first case is where a person has been registered for VAT properly, but where the registration is no longer appropriate.** This will occur where a person was required to register because the person's business activities exceeded the threshold but where, subsequently, **the person's level of business activities has declined to below the threshold**. If the person is continuing in business, then, if the person so wishes, a voluntary registration may be maintained. However, the person should have the right to deregister. Mechanisms are needed to allow a person to remove the person's

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name from the register when this occurs.

- **The second case is where the person has ceased to carry on business activities** (or has ceased to qualify for some reason for voluntary registration). If so, the person's name should be removed from the register whether or not the person applies for deregistration. Subject to safeguards for the integrity of the VAT collection process, deregistration should take place when the person ceases to be entitled to register or no longer wishes to be registered.
- **The third case is where the person has been registered by mistake or by misrepresentation on the part of the person.** In these cases, it will usually be appropriate to provide that the person is removed from the register retrospectively to the moment of registration. In other words, the registering authorities can take action so that the person registered wrongly can be treated as if the registration had never occurred.

Evidence from the Czech Republic

- **Taxable transactions** in the Czech Republic include:
  - **supplies of goods by a taxable person,**
  - **intra-EU acquisitions in an EU country of goods from another EU country,**
  - **supplies of services by a taxable person,**
  - **imports of goods from outside the EU (a third territory or a non-EU country).**
- **The subject to VAT <u>is not</u> supplies of goods by:**
  - **a taxable person established in the Czech Republic, which is not a taxpayer,**
  - **exempt person, which is not a taxpayer,**
  - **taxable person who carries out only exempt transactions without the right for deduction of tax,**
  - **taxable person, which is in another Member State subject to the common flat-rate scheme for farmers or legal non-taxable person.**

Evidence from the Czech Republic

- **A taxable person is:**
  - **A person who, independently, carries out in any place any economic activity, whatever the purpose or results of that activity,**
  - **A person who, on an occasional basis, supplies a new means of transport transported to another EU country.**
- Economic activity includes any activity of producers, traders or persons supplying services, including mining and agricultural activities and activities of the professions.
- States, regional and local government authorities and other bodies governed by public law are not regarded as taxable persons.
- **In the Czech Republic a taxable person becomes a taxpayer when his turnover in the last 12 consecutive months exceeds 1 000 000 CZK. This taxable person becomes a taxpayer since the 1st day of the 2nd month after the month in which the turnover**

Evidence from the Czech Republic

exceeds the limit.

- **This taxable person is obligated to register as a taxpayer in 15 days after the month in which the turnover exceeds the limit.**
- **A taxable person which carries out transactions with a claim for deduction of tax could register voluntarily.**

Example 4

Marek is private florist with its residential address in Pardubice. He purchases flowers from Italy, Spain and Netherlands, makes bouquets and flower compositions and sells them to flower stores, wedding organizers, conference and sports organizers, offices and private costumers in the Czech Republic.

Marek started his business on January 1, 2017 and was not registered as Czech VAT payer so far. During the period from January till June 2017 he had the following purchases of flowers from his Italian, Spanish and Dutch vendors not registered as VAT payers in their domicile countries:

	Purchases from Italy (CZK)	Purchases from Spain (CZK)	Purchases from Netherlands (CZK)
January	50,000	35,000	18,000
February	124,000	18,000	65,000
March	30,000	134,000	21,000
April	43,000	56,000	140,000
May	75,000	10,000	26,000
June	88,000	51,000	45,000

During the period from March until August 2017 he had the following sales:

	Sale of merchandise on invoice (CZK)	Collection of invoice issued (CZK)	Sale of merchandise in cash (CZK)
March	140,000	0	55,000
April	123,000	120,000	121,000
May	189,000	90,000	170,000
June	113,000	98,000	100,000
July	145,000	110,000	189,000
August	156,000	70,000	117,000

Decide if Marek has to register as VAT payer based on his inputs and outputs during 2017. Decide if yes, when Marek has to register as VAT payer based on his inputs from intercommunity acquisitions. Decide if yes, when Marek has to register as VAT payer based on his outputs as local supplies.

Literature

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