6

Value-Added Tax

David Williams

> Not only is the VAT a fairly simple tax, but it is also probably the most popular tax in the world today.
>
> —*Mark Bloomfield and Margo Thorning*

> The concept of value added is not clearcut or easily defined...On the whole, the value-added tax is not nearly as simple a levy as is sometimes argued.
>
> —*John F. Due*

Note: This chapter was produced in parallel with a draft law (the "Draft Value Added Tax Law of the Republic of Fiscalia," accompanied by a commentary). My thanks for help over several years on this chapter, the related papers, the thinking that lies behind them, and the draft law are due in particular to Victor Thuronyi, Richard Vann, and Robin Adair. Frans Vanistendael gave invaluable comments about Western European laws and detailed comments on the entire text. Thanks are also due to my colleagues and students at the University of London, including particularly Nuala Brice, Adrian Shipwright, Gloria Teixeira, Panit Dhirapharbwongse, Junko Isonako, and Carolina Gratenol.

I. Introduction

A. 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.[1] 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.[2] In particular, it is a key common form of taxation for the 15 member

[1] The *taxe sur la valeur ajoutée* was introduced in 1954. For a discussion of its antecedents and evolution, *see* 1 Direction générale des impôts, Précis de fiscalité [*généralités*: two pages preceding ¶ 2000] (1994). The current legislation is in *Titre II, Chapitre premier* of the *Code Général des Impôts*. FRA CGI art. 256 *et seq.*

[2] For a thorough survey, *see* Alan Tait, Value-Added Tax: International Practice and Problems (1988). Since 1988, several of the countries that did not then have a VAT have adopted one. None of the states with a VAT described in Tait, *supra*, has repealed it. On the contrary, the general trend has been to increase the rates of VAT and reduce the exceptions.

states of the European Union.[3] It has also been adopted by Japan,[4] China,[5] Canada,[6] Korea,[7] and many other states in Asia, North and South America, and Africa, besides being adopted in almost all the states of Europe[8] and of the former Soviet Union.[9] 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.[10] Of

---

[3]All EU member states are required to apply the agreed provisions of VAT. The key legislation is found in a series of directives and regulations of the European Union, of which the most important are the First Council Directive 67/227 of Apr. 11, 1967, on the Harmonization of Legislation of Member States Concerning Turnover Taxes, 1971 O.J. (L 71) 1301 [hereinafter the EC First VAT Directive] and the Sixth Council Directive 77/388 of May 17, 1977, on the Harmonization of the Laws of Member States Relating to Turnover Taxes—Common System of Value Added Tax: Uniform Basis of Assessment, 1977 OJ (L 145) 1 [hereinafter the EC Sixth VAT Directive]. For a detailed analysis of this legislation and other relevant aspects of EU law, *see* B.J.M. Terra & Julie Kajus, VAT Legislation of the European Union (1995).

[4] Best termed in English the consumption tax, this tax has a number of special features compared with the tax outlined in this chapter, but it is in essence a tax on value added of the kind discussed here. For a full account in English, *see* Ministry of Finance, An Outline of Japanese Taxes 141-75 (1994). *See also* Alan Schenk, *Japanese Consumption Tax After Six Years: A Unique VAT Matures*, 11 Tax Notes Int'l 1379 (1995).

[5] The People's Republic of China has had a limited form of VAT for some years, but has recently revised and broadened the tax. The current legislation is in Provisional Regulations of the People's Republic of China on Value-Added Tax, adopted by the State Council on Dec. 13, 1993 (CHN VAT), and supplemented by rules for its implementation. Ministry of Finance, Detailed Rules for the Implementation of the Provisional Regulations of the People's Republic of China on Value-Added Tax (Dec. 25, 1993), *reprinted in* Foreign Taxation Administration Department, National Taxation Bureau, A Collection of Tax Laws and Regulations of the People's Republic of China 109 (1994)(in Chinese with English trans.).

[6] The "Goods and Services Tax" (CAN GST) was adopted in 1990 and entered into force on January 1, 1991. It was based on the New Zealand Goods and Services Tax (NZL GST), first adopted in New Zealand in 1985. Major reform of the structure and details of the Canadian tax is currently under consideration.

[7] The tax, translated in English as the value-added tax, was adopted in the Value-Added Tax Law of 1976 (KOR VAT). It broadly follows a simplified version of the form then taken by the VAT in the European Communities (now the European Union).

[8] With the exception of territories of the former Socialist Federal Republic of Yugoslavia, a VAT has now been adopted, or is being considered for adoption, by every state in Europe save some of the smallest. One of the more significant states to adopt a VAT recently is Switzerland, where the population rejected the adoption of the tax at three plebiscites, but agreed to it at a fourth. The Swiss law (French version) is the Ordonnance régissant la taxe sur la valuer ajoutée, of June 22, 1994. The Swiss law broadly follows the form of VAT adopted in the European Union.

[9]The Russian form of VAT (RUS VAT) and those of some of the other countries of the former Soviet Union raise a number of special issues, including relations within the Commonwealth of Independent States. For an analysis of some of these issues, *see* Victoria P. Summers & Emil M. Sunley, *An Analysis of Value-Added Taxes in Russia and Other Countries of the Former Soviet Union,* IMF Working Paper 95/1 (January 1995).

[10]The requirements set out in the directives noted in note 3 *supra* apply to all member states, and candidate members are required to amend their law to conform with it by the time of membership. At the European Council of Ministers conference at Cannes in June 1995, the Council adopted a Commission White Paper laying down terms for convergence toward entry. Preparation of the Associated Countries of Central and Eastern Europe for

the major economies, only the United States and Australia[11] 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.

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."[12] There has therefore been little chance to evolve a settled vocabulary or considered common approach.[13] 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[14] 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,[15] and assists elsewhere in Europe,[16] it does not have competence to act globally. Nonetheless, despite varying names and terminology, the VAT has a common core form throughout the world. That is the focus of this chapter.

Integration into the Internal Market of the Union: White Paper Presented by the Commission, COM(95)163 final. It includes detailed steps to bring indirect taxes in line, particularly, with the requirements of the VAT Directives. *Id.* at Annex. In effect, the terms amount to an early adoption of the principles of the EC form of VAT and a staged adjustment of national laws until all EC requirements are met. The guidance applies specifically to Bulgaria, the Czech Republic, Hungary, Poland, Romania, the Slovak Republic, and Slovenia but by analogy applies to other European states as well. *Id.* ¶ 1.15.

[11]The tax has been actively considered in both states. In the United States, the American Bar Association produced a detailed report and draft law. *See* Committee on Value Added Tax, Section of Taxation, American Bar Association, Value Added Tax: A Model Statute and Commentary (Alan Schenk reporter, 1989). *See also* 3 U.S. Treasury Department, Tax Reform for Fairness, Simplicity, and Economic Growth: The Treasury Department Report to the President (1984). In Australia, the tax was discussed at the government level but rejected after lengthy political debate.

[12]Tait, *supra* note 2, at 3.

[13]*See* Ward M. Hussey & Donald C. Lubick, Basic World Tax Code and Commentary: 1996 Edition, at Title II ("Value Added Tax") (1995)(containing a draft VAT law). The Basic World Tax Code follows the U.S. federal style of drafting (although, of course, the United States does not have a VAT), but is based largely on the same principles as the VAT addressed in this chapter.

[14]However, the Fiscal Affairs Committee of the OECD has in recent years taken a role in monitoring some aspects of VAT within its member states and in the states of Central and Eastern Europe and the countries of the former Soviet Union. It also published a thorough survey of the use of the VAT and similar taxes by the member states of the OECD in 1988. Organization for Economic Cooperation and Development, Taxing Consumption (1988). More recently, it has held regular informal VAT workshops for government officials as part of its program of technical support to the states of Central and Eastern Europe and the countries of the former Soviet Union.

[15]VAT is the responsibility of Directorate-General XV of the Commission.

[16]This assistance is provided by officials and consultants through the PHARE and TACIS funds of the EU.

The aim of this chapter is to examine in detail the legal structure required to implement a broad-based VAT and to draw attention to legal problems requiring solution for the efficient introduction of the tax. The discussion is mainly restricted to the invoice-based credit method of the consumption-type VAT. This is by far the most prevalent type of VAT in use, although there are other forms in existence[17] or as a matter of theory. The chapter does not seek to explore the policy behind the VAT or assess its relative merits as a form of taxation.[18]

B. Terminology

The rapid emergence of the VAT, together with the new concepts involved in the tax, has meant that states have had to invent new words to deal with the tax. Inevitably, these terms have proved inconsistent, even among countries that share a common language. Since the terminology used in a VAT law is instrumental in ensuring the effective working of the law, it is most important that the terminology to be used in any law be considered thoroughly.

For that reason, it is important to note the terms used in this chapter and why they have been chosen. The vocabulary is increasingly used in discussions in English. However, there is no standardized English usage, and the text indicates alternatives where they may help to clarify the underlying concepts. It must also be borne in mind that some of these terms do not translate well into other languages. Consequently, variations occur because of the absence of a common vocabulary.

The name "value-added tax" is not a universal term. The term exists in two English forms: "value added tax" and "value-added tax."[19] Both represent a translation of the original French term,[20] and it might be argued that "added value tax" would be the nearest version, but this is not used. Other states use "goods and services tax." As already noted, this chapter uses

---

[17]The most important example of another kind of VAT is the accounting method consumption tax adopted in Japan. *See* Ministry of Finance, *supra* note 4, at 141, 170-74. This simple form of the tax emerged from the compromise necessary to meet strong opposition when the tax was introduced. It is based on book entries as well as invoices.

[18]This has been done in Alan Tait's important book, *see* Tait, *supra* note 2. *See also* Sijbren Cnossen, *Key Questions in Considering a Value-added Tax for Central and Eastern European Countries,* 39 IMF Staff Papers 211 (1992); Value Added Taxation in Developing Countries (Malcolm Gillis et al. eds., 1990); Howell H. Zee, *Value-Added Tax, in* Tax Policy Handbook 86 (Parthasarathi Shome ed., 1995). For an introduction to VAT policy, the reader may wish at this point to read sec. II of ch. 7.

[19]The former is the style used in the United Kingdom, GBR VAT, and in the English-language versions of EU legislation. *See supra* note 3. The latter is used by Ireland, South Africa, and in the English translations of the laws of a number of states.

[20]The French name is *taxe sur la valeur ajoutée*. The German name is *Mehrwertsteuer* (added-value tax) or *Umsatzsteuer* (turnover tax), the latter being the formal name of the tax under German law. The Spanish name is *impuesto sobre el valor añadido (valor agregado* in some Latin American countries).

the abbreviation "VAT" throughout.[21] The term VAT is preferred to "goods and services tax" or other names because it most accurately reflects the unique nature of this tax.

One example of a term that causes language problems is "supply." The transactions taxed by a VAT are usually termed "supplies" in English-language texts.[22]directives, *supra* note 3, and in the VAT laws of the United Kingdom, GBR VAT § 1, and Ireland, IRL VAT §§ 3, 5. It is also used in Canada, CAN GST § 123(1); New Zealand, NZL GST § 5; South Africa, ZAF VAT §§ 1(lvii), 9; and other English-speaking states. The problem is partly sidestepped in the Basic World Tax Code draft of Hussey and Lubick, *supra* note 13, which focuses on "taxable transactions." *Id.* §§ 201, 211. However, it also uses the term "supply" throughout. *Id.* § 212(c). *See also* the official English translation of the Bulgarian VAT Act of 1993, which refers to "transactions with goods and services." BGR VAT art. 1. The term used in art. 4(1) of the Japanese Consumption Tax best translates as "transfer." *See* Ministry of Finance, *supra* note 4, at 141. VAT laws in the Russian language typically use the term *oborot* (turnover). RUS VAT arts. 3, 4; KAZ TC art. 54. The term does not translate easily and directly into French, German, Russian, or Spanish. Nor have those languages evolved a single term equivalent to "supply." For example, the French law refers to *les livraisons de biens meubles et les prestations de services*. Consequently, this key term cannot be used in states using those languages. Similar problems are encountered in Japan, where the law refers to "transfers of assets, etc."

A second example is the link between the term "supply" and that of "goods or services." In some laws, the emphasis is separately placed on "supply" and "goods and services," while in others—for reasons just noted—the focus is on "supply of goods" and "supply of services." Again, English usage is not itself entirely consistent,[23] but problems arise in other languages both over this point of linkage and also with the terms "goods and services."[24]

A final example shows language reflecting underlying differences in legal systems. The example is the next phrase in the EC version of the charge to VAT, namely that the tax is imposed on "the supply of goods or services *effected for consideration*."[25] The term "consideration" carries a particular technical meaning in common law states where it forms a

---

[21]This abbreviation (or its equivalent in the relevant language) is now also used in some national legislation. *See, e.g.,* the recent U.K. consolidation measure, the Value Added Tax Act, 1994, ch. 23 (GBR VAT)(referring to "VAT" throughout).

[22] This is the term used in the English version of the European Union

[23] Hussey and Lubick, *supra* note 13, talk of "goods or a service." *Id.* § 211(a)(1). Like other English-speaking lawyers, they find it difficult to use the term "a good" despite its prevalent use among economists.

[24] As noted below, the Russian law and other laws similar to it refer to "goods, work, and services" because the term "services" has a narrower meaning in Russian than the concept expressed by the English word. *See* RUS VAT arts. 1, 3.

[25] EC Sixth VAT Directive, *supra* note 3, art. 2(1).

constituent element in the legal formation of a contract.[26] The term does not carry the same significance in states of the civil law tradition and cannot be directly translated. The French term is *effectuées à titre onéreux*.[27] It might be translated better as "against payment."[28] This approach is used in this chapter, although alternative approaches to avoid the term are used in some states.[29]

C. 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. There are several ways in which that result can be achieved, as Tait discusses.[30] This chapter discusses only one, the method often called the invoice-based method, which is the most widely used. It requires the VAT to be identified in respect of each transaction or group of transactions.

The formal principles of this method are set out in the EC First VAT Directive[31] as follows:

---

[26] This caused problems in the English courts in the case of *Customs and Excise Commissioners v. Apple and Pear Development Council*, [1984] Simon's Tax Cases [S.T.C.] 296 and [1985] S.T.C. 383, where the lower courts mistakenly focused on the technical English law meaning of the term, but questioned by the House of Lords, [1986] S.T.C. 192, and referred by them to the Court of Justice of the European Communities, which court, [1988] S.T.C. 221, emphasized that the term had common meaning throughout the European Communities (now the EU). The case well illustrates the dangers, emphasized here, of wrong terminology in this tax.

[27]Deuxième Directive 67/228 du Conseil du 11 avril 1967 en matière d'harmonisation des législations des Etats membres relatives aux taxes sur le chiffre d'affaires—Structure et modalités d'application du système commun de taxe sur la valeur ajoutée, art. 2, 1967 J.O. (L 1303) 67, 68; *see also* FRA CGI art. 256; CHE OTVA art. 4.

[28]This is the English-language text used in the (now superseded) Second Council Directive 67/228 of Apr. 11, 1967, on the Harmonisation of Legislation of Member States Concerning turnover Taxes—Structure and Procedures for Application of the Common System of Value Added Tax, art. 2(a), 1967 O.J. (L 71) 1303, as an alternative English equivalent of the French phrase in the text (which did not change between the Second and EC Sixth VAT Directives).

[29]The New Zealand goods and services tax is imposed on supplies "by reference to the value of [the] supply." NZL GST § 8. A similar approach is taken in the Basic World Tax Code. Hussey & Lubick, *supra* note 13, § 221(a). The U.K. legislation links the concepts in a different (and, in the view of this writer, a less satisfactory) way by defining "supply" as including "all forms of supply, *but not anything done otherwise than for a consideration.*" GBR VAT § 5(2)(a)(emphasis added). A difficulty with any such formulation is that some supplies that are not for consideration are taxable—for example, personal use of business assets—requiring a reference to deemed consideration.

[30]Tait, *supra* note 2, at 4–9.

[31]First VAT Directive, *supra* note 3, art. 2 (in part). The EC First VAT Directive provides the framework for the single form of VAT adopted by the European Union. *Id.*

> 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.

The following is a simplified example of the operation of the VAT on these principles, involving *X* (who creates an item of household goods from raw materials acquired without costs), *Y* (who runs a shop and buys the goods direct from *X* to sell to the public), and *Z* (the customer who buys the goods for personal use). *X* sells the item to *Y* for 100 (ignoring the VAT), and *Y* sells the item to *Z* for 300. The value added by *X* is therefore 100 and by *Y* is 200. *X* and *Y* are both fully registered for the VAT. The rate of VAT is 10 percent.

> *X* sells the item to *Y* for 100. The sale is subject to VAT at 10 percent, so *X* must add this to the price. *Y* therefore pays 110. *X* must account to the tax authorities for the VAT, 10, keeping a profit of 100. *Y* therefore pays 110 for the item.
>
> *Y* sells the item to *Z* for 300. The sale is subject to VAT at 10 percent, so *Y* must add this to the price. *Z* therefore pays 330. *Y* is entitled to be paid back for the VAT paid out to *X*, so retains 10 of the VAT collected. *Y* must account to the tax authorities for the other 20, keeping a profit of 200. *Y*'s profit remains at 200 because the net cost of *Y* buying from *X* is 100, not 110.
>
> The tax authorities receive 30 in total, 10 from *X* and 20 from *Y*. This reflects the value added by both *X* and *Y*.
>
> Further, assume that *Z* is also a trader registered for VAT and buys the item from *Y* for 300 plus VAT. However, *Z* is unable to sell the goods for a profit, and instead sells them to another private customer, *W*, for 280 plus VAT.
>
> *Z* therefore pays 330 for the item. *Z* sells the item to *W* for 280. The sale is subject to VAT at 10 percent, so *Z* must add this to the price. *W* therefore pays 308. *Z* is entitled to be paid back for the VAT paid out to *Y*, so retains the full 28 VAT collected. Further, *Z* is due a rebate of 2 against other sales. *Z* will therefore claim a rebate of 2 from the tax authorities.

In this example, *X* and *Y* both added value on their sales. *Z* lost value. The tax authorities receive 10 from *X* and 20 from *Y* but must rebate 2 to *Z*. This totals 28 across the transaction as a whole, ensuring that the proper amount of VAT is paid. Note that if *Z* is not allowed a rebate (or, as in some of the countries of the former Soviet Union, if *Z*'s loss is not recognized for VAT purposes), then the tax on the combined transactions is excessive.

D. 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. Attention must also be paid to the person to be charged to VAT on the transaction, to ensure that the amount of VAT due can be enforced and collected. It is therefore necessary to provide rules to determine the identity of the person responsible for payment of the VAT when some element of the transaction being taxed takes place outside the jurisdiction of the state.

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 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 charge is to be a discriminatory border charge. This would avoid the absence of a VAT, but not the double taxation. (An alternative adjustment mechanism, whose implications are beyond the scope of this book, is the exchange rate between the currencies of *A* and *B*.)

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.

In practice, however, and with limited exceptions,[32] 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,[33] but these practices are limited exceptions to the general approach. In this chapter, we therefore assume that the VAT is to be based on the destination principle. This requires a charge to VAT on all transactions occurring within the state and also on all imports to the state.

To impose tax on both groups of transactions, VAT is normally imposed by two parallel sets of provisions:

(a) provisions imposing VAT on all transactions within the state; and
(b) provisions imposing VAT on all transactions involving imports to the state.

This pattern is adopted in this chapter, and the question of taxation of imports is dealt with separately from the matter of transactions treated as fully within the territorial scope of the tax.

E. Internal Charge to 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,*[34] 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.

---

[32] The main exception is that of Russia and states within the Commonwealth of Independent States, adopting an origin basis. *See* Summers & Sunley, *supra* note 9, at 26 *et seq.*

[33] The European Commission has formally proposed that the European Union change from the present destination basis to a form of origin basis, originally for 1997 for transactions within the EU, although that date has now been deferred. *See* 1990 O.J. (C 176) 8. At present, no consensus exists to take this proposal forward on a general basis.

[34] From the supplier's point of view, it is an output.

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.

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

(a) the transactions are "supplies of goods and services;"[35]
(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.

Each aspect of this approach to charging VAT is examined below.[36]

F. 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).[37] This is the approach adopted in this discussion.

Having identified imports of goods as a separate occasion for charge, the normal practice of states is to use their customs laws as a vehicle for imposing the VAT on goods that are imported, subject to necessary modifications. The nature of appropriate modifications is discussed below.

G. Principle of Nondiscrimination

---

[35] The summary adopts the terminology used in this chapter. Note, however, the reservations against any particular set of words already noted above.

[36] *See infra* secs. II–IV.

[37] The distinction is not merely semantic. An import of goods is taxable regardless of the identity of the supplier or person supplied. By contrast, an "import" of services is taxable only if the supplier (or person supplied) is a taxable person. Since there is usually a registration threshold for VAT, a foreign supplier that supplies only services with a low annual value may not be a taxable person. In the case of imported goods, the importer is made liable for the VAT regardless of that person's status. In the cases of services, the person receiving the services may be responsible for the VAT under a reverse charge (*see infra* text accompanying note 89), but registration will still be required for this to be effective.

The existence of separate charges on locally supplied goods and imported goods gives rise to the possibility of discrimination between the two classes of supplies. Most states are obliged by international agreement not to discriminate against supplies by way of import. The primary source of this obligation is Article III of the General Agreement on Tariffs and Trade.[38] The key part of that article provides:

> 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.

A growing number of states are also under other obligations not to discriminate through their indirect taxes. Sources of such obligations include the terms of customs unions and free trade area agreements,[39] double tax agreements,[40] Article 24 of the United Nations Model Double Taxation Convention Between Developed and Developing Countries contains a provision that is identical to an earlier version (the 1977 version) of the OECD Model Tax Convention. U.N. Dep't of Int'l Economics & Social Affairs, U.N. Model Double Taxation Convention Between Developed and Developing Countries at 39, 207, U.N. Doc. ST/ESA/102, U.N. Sales No. E.80.XVI.3 (1980). The only differences with the present OECD provision are drafting changes. Baker, *supra,* at 384. The model form of wording is found widely in individual double taxation conventions, although some states do not adopt it. The United Kingdom recorded a reservation to paragraph 6 in the OECD Model Tax Convention commentary, but no other state has done so. *Id.* at 413. and bilateral trading and investment agreements.[41]are still in force. The modern practice is to negotiate bilateral investment protection agreements. These sometimes include similar clauses. The principle therefore requires some modifications of customs law (which is of its essence a charge designed to discriminate). This is also discussed below.

---

[38] Text adopted in 1947. The GATT 1947 (as amended before 1995) along with various protocols, decisions, waivers, and understandings make up the GATT 1994. Therefore, the obligation remains valid. Indeed, its scope is potentially widened to cover some services as well as products (or goods—the terms are effectively interchangeable).

[39]An example is art. 95 of the Treaty Establishing the European Community (and directly operative in all the member states of the EU). This imposes an obligation on all member states not to use internal taxation of products to favor locally produced goods over similar goods from other member states, or so as to cause indirect discrimination of that kind. The article has lead to considerable litigation within the EU and before the European Court of Justice. *See* Stephen Weatherill & Paul Beaumont, EC Law, chs. 6, 14 (1993).

[40] Article 24 of the OECD Model Tax Convention on Income and on Capital of 1992 [hereinafter OECD Model Tax Convention], *reprinted in* Philip Baker, Double Taxation Conventions and International Tax Law (2d ed. 1994), contains a provision prohibiting discrimination between the two states that are parties to the agreement with respect to the nationality of taxpayers. Although most provisions in the OECD Model Tax Convention are confined to direct taxes, art. 24(6) applies this article to all forms of tax. Therefore, it potentially covers the VAT.

[41] The earliest nondiscrimination clauses (usually in the form of national treatment clauses or most-favored-nation clauses) are in treaties of friendship, commerce, and navigation, some of which were first negotiated in the fifteenth century. Many friendship, commerce, and navigation agreements

To ensure that a state complies with these obligations, the structure of its VAT must be nondiscriminatory. This requires that the imposition of VAT on imports of goods or on services originating outside the state must not be in excess of the charge on internal transactions.

II. Taxable Persons

A. Persons Within the Scope of the Law

A person within the scope of VAT is usually described as a taxable person.[42] This terminology avoids the confusion caused in some states by calling such persons "taxpayers." The confusion arises because the taxpayer, in the sense of the person bearing the economic incidence of the tax, is the person receiving a taxable supply. This also applies for calculating the direct tax on a supply. For example, in the case of a supply of property rights on which a royalty is paid, the person supplying the rights is the taxable person for VAT purposes (while the person paying the royalty to the taxable person is in the economic sense the taxpayer), and the taxable person is in both law and practice the taxpayer of any income tax in respect of the receipt of the royalty.

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

[42] This is the term used in the English-language version of the EC Sixth VAT Directive, *supra* note 3, art. 4. It is also used in the Irish Value-Added Tax Acts, IRL VAT § 8; the Basic World Tax Code, Hussey & Lubick, *supra* note 13, § 213(b); and the Singapore Goods and Services Tax, SGP GST § 8(2). The French term is *un assujetti*, although the term *redevable* is also used. *See* FRA CGI art. 256; CHE OTVA art. 4; *see also supra* ch. 4, note 17. The English term used in Ministry of Finance, *supra* note 4, is "taxpayer." Venezuela is an example of a state with a general tax law (the Organic Tax Code) that lays down general rules about "taxpayers." VEN COT arts. 22–24. It also makes provision for "persons responsible," namely, those who are not taxpayers but who have responsibilities to collect or pay tax under tax legislation. *Id.* at arts. 25–29. Because of this, the Venezuelan Wholesale and Luxury Tax, as the local equivalent of a VAT is called, applies to "taxpayers" as defined in the Organic Tax Code and "persons responsible." VEN IC art. 1; VEN COT arts. 22, 25–28. This leaves the precise personal scope of the VEN IC to be defined by the general tax code. The New Zealand law uses the term "registered person," but makes it clear that a person is to be treated as a registered person if the person is not registered in cases where the person should be registered. NZL GST § 2(1)(defining "registered person" as "a person who is registered or is liable to be registered under this Act"); *see also* GBR VAT § 3(1)("A person is a taxable person for the purposes of this Act while he is, or is required to be, registered under this Act."). Both the United Kingdom and New Zealand have high taxpayer compliance. The term used in this chapter does not assume compliance.

may need to reflect this. In some legal systems, they do not have separate juridical personality.[43] A VAT law may regard an association or partnership as a taxable person separate from the individuals in the association or partnership, although the association does not, for general legal purposes, have separate personality. This is consistent with an intention of excluding from the scope of the tax individuals engaged only in noncommercial activities.

If separate registration of a partnership is provided for, a mechanism should be introduced to give effect to the recognition. This will treat the partnership as making or receiving all relevant supplies and will ignore those supplies as being made by the partners (even though, for other legal purposes, the reverse is the actual legal position).[44]

Some states also allow or require[45] separate branches of a juridical person to be regarded as separate taxable persons (in which case a supply by one branch to another branch is a taxable supply) or allow groups of companies (e.g., a parent company and its subsidiaries) to register together as one taxable person (in which case a supply by one of the companies to another will not be a taxable supply). Where separate branches are treated as separate taxable persons, or groups of companies are treated as one taxable person, some administrative machinery is necessary to recognize the branches and groups.[46]

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 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

[43] For example, in Germany, Latvia, and many common law states. In civil law states, joint ventures may not have separate legal personality. The United Kingdom has an even more complex situation whereby partnerships have legal personality in part of the state (Scotland) but not in the whole state. *See also* ch. 3, sec. V(D); vol. 2, ch. 21.

[44] For a clear example of this kind of provision, *see* NZL GST § 57.

[45] For example, Kazakstan did so before July 1, 1995.

[46] The corporate income tax legislation of many states recognizes the joint treatment of a group of companies for income tax purposes. These laws provide, for example, a definition of the link creating a group (perhaps a 50 percent or 75 percent shareholding by the parent in the subsidiary). They often reflect the accounting convention of the integration of the activities of subsidiary companies into the accounts of the parent. They might be used by analogy for the VAT. Few states, however, recognize registration for separate divisions for direct tax purposes. Separate registration may prove advantageous for VAT purposes by allowing, for example, a split between the taxable activities of a company and nontaxable activities where those separate groups of activities are carried out by different divisions of a company or organization. It will also allow a trading division within a public body to register, while the main body remains unregistered.

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.[47] A similar approach could be adopted for the VAT.[48]

Governmental bodies at the national, regional, and local level are to be included as taxable persons, in the same way as any other person, if they engage in economic activity. It is appropriate to except from this full rule "the central lawmaking and executive authority of the state," as no useful purpose is served in normal situations by such an inclusion. These institutions rarely engage in business activities. By definition, the main activities of the state legislature and the state's central governmental agencies are sovereign activities of the state and not commercial activities. This is also true of the activities of the judiciary in the state courts. It may be felt appropriate to provide a definition clarifying which of these bodies are expressly excluded from the scope of the VAT. The precise terms used need to be adapted to make sense in the context of the organization of government of the particular state.[49]

B. Excluding Persons with Low Levels of Business Activity

Most states require only some of the many persons active in business within the state to be taxable persons.[50] 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

[47] OECD Model Tax Convention, *supra* note 40, art. 5.

[48] The key test for registration is normally whether a taxable person makes supplies of the required level within the state. For that purpose, it does not matter in what form the supplier is present in the state—although in practice it may prove difficult to identify the person who ought to register by reason of a single transaction. Residence is, however, relevant to some supplies of services and for certain procedural purposes (e.g., nonresidents being required to appoint a resident tax representative). One approach that accepts this problem is that of the United Kingdom in providing that "a supply of services shall be treated as made . . . in the United Kingdom if the supplier belongs in the United Kingdom . . . " GBR VAT § 7(10). A supplier of services is treated as "belonging," if there is a business establishment in the country. *Id.* § 9(2). Either a branch or an agency is treated as a business establishment. *Id.* § 9(5)(a). "Branch or agency" is the phrase used in U.K. income tax law instead of "permanent establishment." GBR ICTA § 11. The phrase used in the underlying EU law is "fixed establishment." EC Sixth VAT Directive, *supra* note 3, art. 9. The French term for this is *établissement stable*. FRA CGI art. 259. This is the same term as that used in the French version of the OECD Model Double Tax Convention for "permanent establishment." OECD Model Tax Convention, *supra* note 40, art. 5. It is used directly in the French law, CGI art. 259, and the French version of the Swiss law, OTVA art. 9. It must also be noted that the concept of permanent establishment is not without its own problems. For example, if a business has a permanent establishment within the jurisdiction, is that establishment deemed to supply all supplies made to the jurisdiction by the company, even though they are not made through the permanent establishment? It may be so treated under the "force of attraction" principle, *cf. e.g.,* KAZ TC art. 5, which is, however, rejected by many treaties for income tax purposes.

[49] For the position relating to the diplomatic and consular functions of the state, *see infra* sec. IV(K).

[50] Some states, however, require all legal persons to be registered and have a minimum limit for individuals only. States may also exclude certain kinds of activity (e.g., excluding retailers but taxing wholesalers). This is usually considered problematic and contrary to the spirit of the VAT.

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.[51]for a set period, the result may be seen to be unfair.

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 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 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.[52]as the minimum monthly or annual wage. The threshold then adjusts automatically with that factor.

This discussion assumes that a law has only one registration limit. Some states have more than one limit, for example, a lower limit by reference to the supplies of services or of certain kinds of services, and another, higher limit for the supply of goods.[53] This allows the state

[51] The threshold will need to be defined with some care. There are two bases for definition: actual turnover of taxable supplies over a defined period and estimated turnover over a defined period. The test may be based on past periods (when actual turnover can be used), future periods (when estimates must be used), or a period such as the current calendar year, which is both past and future. An estimate might be based on the amount that it is reasonable to assume or, alternatively, likely that the business will exceed. The advantage of including estimates is that this allows registration to be made mandatory before the threshold is reached. This makes for easier enforcement. However, there will be situations where the estimate proves to be too high, and registration is forced in a case where it was not objectively required. In such a case, if other provisions force a registration to remain

[52] This provision is extremely sensitive in economies with high inflation. In some states that have severe problems with inflation, but that may not have a well-developed index of consumer prices, the practice has been adopted of linking the threshold not to a set sum of money but to an indexed factor, such

[53] This happens in Ireland, where the higher limit applies to traders with at least 90 percent of their taxable turnover deriving from the sale of goods, with the lower threshold (about half the level of the higher threshold) applying to all other taxable persons. IRL VAT § 8(3)(c), (e).

authorities to impose limits that reflect the different proportions of value added involved in providing goods and providing services, although it can do so only by adding another level of complexity. A provision setting more than one threshold will also need to provide a definition of the kinds of supply that count toward the lower level rather than the higher level and to provide for those who make both kinds of supply.

It should be emphasized that the threshold limit applies to all supplies made by one person or by that person's agent for the person. It is possible for a person who is potentially a taxable person to avoid that result by transferring some of the person's activities to another person (who might be under common ownership with the person transferring). States concerned by such practices may adopt provisions requiring that the total of activities in such situations be added together and be deemed to be the activities of one taxpayer.[54]

It must also be clear that, apart from aggregation rules, the threshold applies separately to each taxable person. For example, if *A* and *B*, both being active in business independently, also form a partnership, then the threshold applies separately to the taxable turnover of *A*, of *B*, and of the partnership.

C. A VAT Register

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."[55]

D. VAT Numbers

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

[54] An example of this kind of antiavoidance provision is found in the United Kingdom. GBR VAT Sched. 1. This was strengthened considerably by the U.K. Finance Act 1996, sched. 3. The tax authorities can treat a series of separate companies as carrying on one trade so as to require them or one of them to register on behalf of the "group." The Japanese law has a "substantial attribution" rule based on similar rules for the direct taxes under which those who substantially enjoy consideration for transfers are regarded as the entities making the transfers. *See* JPN CTL art. 13; Ministry of Finance, *supra* note 4, at 159. A taxable person manipulating levels of transfer will be within the scope of this provision.

[55] *See supra* note 42.

person,[56] 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.

The VAT number is used by the tax authorities and by taxable persons themselves to ensure the proper operation of an invoice-based VAT. Every invoice is important to the tax authorities wishing to collect the VAT recorded on it and also to any taxable person paying the VAT recorded on the invoice to ensure deduction of the input tax on the invoice. For this reason, it is necessary to be able to identify the taxable person charging the VAT on the invoice. The law should provide that a taxable person is under a duty to put his, her, or its VAT number on the invoice, so that this can be achieved.

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 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.

E. Voluntary Registration

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.

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.[57] Such persons should not be entitled to register unless they are genuinely

[56] The precise nature of the number used, and its status as a unique registration number for VAT purposes, is particularly important where the registration number is used in international transactions. Best practice will require both that the number identify the taxable person by reference to the state issuing the number and that the number contain a check digit so that routine checks can be made against mistakes and deliberate wrong use of numbers. International identification is provided within the EU by a standard international prefix. The check digit requires that the number be issued or monitored using standard mathematical methods.

[57] Some of the states adopting a VAT in recent years have experienced problems with this kind of fraud.

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.

A second reason for limiting voluntary registration is that the right to register voluntarily may have the effect of making many more persons "taxable persons" than is administratively appropriate for the state, particularly when a VAT is first introduced and the state has chosen to set a high threshold level.

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 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.

F. Exporters and Persons Engaged in International Activities

Most states provide that there is no VAT on exports.[58]*See supra* sec. I(D). To avoid exporters paying VAT, provision is made for them to claim back any input tax they have paid in making the exports (see below). Therefore, exporters and those in a similar position must be brought onto the register. If they are not on the register, they will not be entitled to claim rebates of input tax, and their activities will be affected. An exporter may not have a level of activity great enough to be above the minimum level requiring registration. Any provision in the law having the effect of excluding voluntary registration must therefore be accompanied by another provision ensuring that exporters are allowed to register regardless of their level of activity.

G. Effect of Nonregistration

A person who is required to register for the VAT is a "taxable person" who is subject to the duty to impose and collect VAT on all supplies whether or not the person is registered. It is important that the law make this clear and not exclude a person from the scope of the law just because of a failure (deliberate or otherwise) on the part of the person to apply for registration. It will also be appropriate to impose penalties on those who should have applied for registration but have failed to do so, as well as to ensure that full powers exist to collect VAT from those persons in respect of all supplies that have taken place (or are assumed or estimated to have taken place) when the person was not registered but should have been registered.[59] However, such a person is

[58] This follows from adoption of the destination basis of taxation.

[59] The amount collected is typically reduced by input tax credits supported by invoices.

not entitled to issue VAT invoices. Hence, the person's customers cannot claim input tax credits in respect of supplies from such a person.

The converse to this position should also be made clear in the law. A person who is not registered for VAT and is not required to be registered is outside the scope of the law. A person outside the scope of the law has no right to claim a rebate for any input tax paid. The person also has no right to impose VAT, or anything purporting to be VAT, on supplies made by the person. To ensure that persons do not abuse this position, two safeguards may be put in place. First, a person who collects or tries to collect VAT while not empowered to do so is made liable to criminal penalties. Second, the VAT law provides powers to collect the sums of money from such a person although the sums are strictly not VAT.[60] A variant on the second provision is to ensure that the overpaid VAT is repaid to the person overpaying.

H. Cancellation of Registration

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 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.

The charging provisions of the law should deal with VAT liability that arises by reason of a person ceasing to be registered. In addition, the powers of the tax authorities should remain in place notwithstanding the deregistration to deal with such charges.

[60] The New Zealand law provides the Commissioner of Taxes with the power to collect the tax in these circumstances by an assessment if "[a]ny person, not being a registered person, supplies goods and services and represents that tax is charged on that supply . . ." NZL GST VAT § 27(1).

Safeguards are needed to deal with those who have been registered, but should not have been registered, and for those who appear to be registering properly, but who use registration to obtain large refunds of input tax without later paying in any corresponding output tax. In part, these safeguards may be linked to the grant of refunds for input tax.[61] Some states add further safeguards, for example, preventing a person who has registered voluntarily from deregistering within a set time (perhaps one or two years) of first registering.[62]

J. Continuing a Registration Despite a Change in the Taxable Person

Situations will arise where a person ceases carrying on a business unavoidably. For example, the death, incapacity, or insolvency of an individual or the winding up of a company may mean that the person registered as running a business is no longer running it. The business will usually continue at least for a time to be run by some other person. For example, the trustee in bankruptcy or a receiver for a debtor may run the business in the owner's place, and the personal representatives of a deceased person will often run the business until it can be transferred to some other person. In these cases, states often make provision to treat the registration as continuing notwithstanding the change in identity of the taxable person. Rules might deal similarly with changes in membership of a partnership where the partnership continues to run the business without a break. These provisions should be linked with other provisions preventing a transfer of title in cases of continuing registration from constituting a supply. The rules can be more liberal than the reorganization provisions of the income tax.[63]

III. Supplies of Goods and Services

A. Transactions within the Scope of the Law

A broad-based VAT is designed to bring within its charge every kind of economic transaction, subject to limited exceptions. This is normally achieved by drafting a very broad provision imposing VAT on an extremely wide range of business transactions and then removing by specific exception any transaction that is not to be liable.

Transactions are usually stated to be within the scope of VAT if they are "supplies of goods or services." These terms are given extremely wide meanings that go significantly beyond the usual meanings of "supplies," "goods," and "services" in most languages. The aim is to bring within the charge all economic activity. In particular, the terms need to cover transactions

[61] *See infra* sec. VII(L).

[62] For example, the limit in Japan is two years. JPN CTL art. 9.

[63] I f a reorganization were to be considered a taxable supply, the successor entity would obtain an input tax credit in the same amount. The logic of VAT does not require tax to be imposed in such a situation, as long as the successor continues to be a taxable person. *See also infra* sec. VII(E).

dealing with land or other immovable property and with intellectual property rights. Therefore, the terms should not be limited to the meanings of those terms, for example, in consumer law.

For reasons of linguistic simplicity, all the relevant transactions are termed "supplies" in most English VAT texts. However, there is no one concept of "supply" in many languages.[64] A more formal presentation of the scope of a VAT law might refer to (a) transactions involving the transfer of the legal rights to goods, and (b) other transactions within the scope of VAT but not involving such a transfer.

In actual drafting, one can employ less clumsy expressions than this, as long as the underlying intent is not lost. The discussion will deal with the formal classification.

Besides identifying what transactions are within the scope of the VAT, rules are required to determine where transactions occur, when they occur, and who for the purposes of VAT is carrying out, or treated as carrying out, the transactions.

B. Supplies of Goods

VAT laws usually contain a definition of a "supply of goods" or "goods." It is felt, in the light of the formal presentation above, that the better practice is to offer a definition of a "supply of goods." Again, the definition needs to avoid being too closely related to any definition of a similar concept in the commercial or consumer law of the state. This is because the scope of the VAT rule will usually be wider than the scope of the commercial law. Other rules, such as timing, may also be different. Nonetheless, those defining a "supply of goods" in the VAT context might well gain from reviewing the other definitions within the state of those terms.

A possible definition[65] of a "supply of goods" is a transfer of the right to dispose of tangible movable property or of immovable property other than land.[66]of services, and leasing is

[64] *See supra* sec. I(B).

[65] The EC Sixth VAT Directive defines "supply of goods" as "the transfer of the right to dispose of tangible property as owner." EC Sixth VAT Directive, *supra* note 3, art. 5. This is an English rendering of the French "*le transfert du pouvoir de disposer d'un bien meuble corporel comme un propriétaire*," FRA CGI art. 256, and does not fully convey the civil code technicalities of the French version. The Swiss-French version is "*le pouvoir de disposer économiquement d'un bien en son propre nom.*" CHE OTVA art. 5. The U.K. law does not define "supply" (beyond saying that it includes all forms of supply, GBR VAT § 5(2)(a), a formula also adopted by the New Zealand law, NZL GST § 5(1)), or "goods" (defined in New Zealand, NZL GST § 2(1)) or "supply of goods." The Basic World Tax Code defines supply as "the act of providing a good or service . . ." Hussey & Lubick, *supra* note 13, § 212(c).

[66] Some definitions also expressly exclude "money" from the definition. For example, the New Zealand definition states that "goods" includes "all kinds of personal or real property; but does not include choses in action or money." NZL GST § 2(1). (Chose in action means a right to bring a lawsuit or to recover a sum of money.) This is the widest definition possible in the context of the present form of law. Other forms of property such as intellectual property are therefore not goods. This is, however, an approach made within the context of the common law. Other systems of law do not draw the same distinctions between tangible and intangible property. For example, under the Japanese consumption tax law, the leasing of assets (goods) is treated in the same way as sales of assets and separately from the provision

defined to include transfers of intangible property in assets. *See* Ministry of Finance, *supra* note 4, at 145. The consequence of this form of definition, coupled with a broad definition of services (see sec. D below), is that the transfer of intangible property will be considered a service.

The problem with a general definition of this concept is that there are fundamental differences in approach to the sales of goods in different legal systems, including differences within the European Union between common law states and civil law states. The definition offered here is a compromise between the common law and civil law approaches to property. The definition in a state may need to be aligned more closely with the property laws of that state.

For example, the common law approach identifies property as tangible (items that can be held or touched—usually referred to as goods or products in commercial laws) and intangible (property that cannot be touched, such as legal rights). It also distinguishes between "personal property" (including tangible property that can be owned by individual persons, such as goods) and "real property" (this includes only legal rights of ownership to land and things attached to or inseparable from land). In countries with a civil law tradition, a distinction is drawn between movable property and immovable property on a differing basis (e.g., a building can be treated as separate from the land on which the building stands, and the categories of immovable property may be related more to the physical ability to move the property than to the underlying legal rights). VAT laws may not precisely follow either of these approaches. The objective of the VAT rule is to impose tax on the economic substance of what is occurring (and for which a person receives payment) rather than on its precise legal form.

A "supply of goods" is not constituted merely by a transfer of possession, which is a transfer of the use of goods, not of the goods themselves. A transfer of the use of goods is a supply of services. What constitutes the right to dispose of property depends on the laws of each state. The definition set out above avoids reference to a sale of the goods or the rights of ownership. The intention is to avoid complexities of the commercial laws of a state, such as reservations of title, that may prevent ownership from transferring but that do not prevent all the physical attributes and economic value of ownership from being transferred. Equally, a transaction that has all the attributes of a sale but later turns out to be avoidable for legal reasons does not thereby cease to be a supply, although there may later be a supply back again if the goods are transferred back.

If a transfer of possession (a supply of a service) is followed by a transfer of the title, or rights of ownership, the supply of goods is the supply of those rights and reflects the residual value after taking into account the value of the services already supplied.

No separate definition of "goods" is needed save the explanation in the above definition or its equivalent.[67] The intention is to include in the category of "goods" all those forms of

---

[67] For alternative approaches, *see supra* notes 65 and 66; *see also* Hussey & Lubick, *supra* note 13, § 212(a), (c) (defining "goods" as well as "supply"). For a lengthy definition of "supply," *see* NZL GST § 5.

tangible property that are to be within the scope of the tax. Land is often excluded from the definition of goods deliberately for reasons discussed below. Sometimes money is also excluded. This will depend in part on how money is viewed in the property laws of a state (particularly, whether money is regarded as tangible or intangible). In reality, whether or not money is excluded here, all forms of VAT exclude a charge to VAT on transfers of money (or, properly, the use of money) by exemption. Any exclusion of property or transactions from the definition of "supply of goods" will bring it within the definition of "supply of services" set out below, thereby requiring the exclusion to be set forth again.

Many laws also extend the definition of supplies of goods to cover supplies of energy and other kinds of supply that are similar to goods. For example, a supply of electricity is not generally treated under civil or commercial law as a supply of goods, nor is a supply of heat, refrigeration, or air conditioning. However, it is usually regarded as convenient to treat them as supplies of goods to apply the timing and location rules that relate to goods.[68]

C. Land

The reference to "immovable property other than land" is designed to take account of the fact that some states have wider definitions of immovable property than other states. Whatever the scope of the definitions within a state, a sale of land should be excluded from the scope of a supply of goods.[69] "Land" in this context means the rights of a person as the owner to legal title and exclusive possession and control over any part of the surface or subsoil of the territory of the state. The emphasis is on the legal title, not on the actual soil. This may or may not automatically include legal title and possession of any buildings, structures, or equipment fixed to the surface or in the subsoil.[70]

The reference to legal title is based on the assumption that the law of the state provides for the sale of the whole legal interest in land. In a number of states, only limited sales of interests in land can occur and to that extent the comments are not relevant. Another point of difference in the laws dealing with land or immovable property of states is that some states have laws under which a building on land is legally regarded as part of the land, and so cannot be sold

---

[68] The EC Sixth VAT Directive requires that "[e]lectric current, gas, heat, refrigeration, and the like shall be considered tangible property." EC Sixth VAT Directive, *supra* note 3, art. 5(2).

[69] Compare the New Zealand definition set forth in note 66, *supra*, as one attempt to widen the scope of the tax to cover certain land transactions. For the policy behind the statement, *see* Tait, *supra* note 2, at 61-66, 80-90; *see also* ch. 7 *infra*. It may be noted that the New Zealand law contains a number of exemptions removing certain transactions involving land from the scope of the tax. It was found necessary on more than one occasion after the passage of the act to widen those exemptions, despite the clear policy in New Zealand against such exclusions.

[70] In the preliminary edition of the Basic World Tax Code, Hussey and Lubick catered to this by separately excluding land and "existing buildings" from the definition of "goods." Ward M. Hussey & Donald C. Lubick, Basic World Tax Code and Commentary § 212(b)(2), (3) (1992). Section 212 of the 1996 edition now includes land and buildings. For an explanation of the change of view of the authors, *see* Hussey & Lubick, *supra* note 13, at 289.

separately from that land.[71] In other states, a building can be sold even where the land is not sold or cannot be sold.[72] The suggested definition will have different effects in these different situations. Consideration will need to be given to the adaptation of the law to the situation applying in the state.

Exclusion of land from the definition of goods is for reasons of both principle and practical administration. Some of the arguments from principle are reviewed in the chapter by Cnossen[73] and are not rehearsed here. A practical problem is how best to tax works or buildings on land without also taxing the land. There are several possible solutions to the problem of taxing development (including buildings) and not land. The methods used in OECD states are also reviewed by Cnossen.[74]

If a law adopts the definition set out above, a sale of undeveloped land is never subject to VAT. A sale of land by a private person would not, in any event, be within the scope of the tax, because the sale would not be part of a business activity, and, in many cases, the seller would not be a taxable person. The transfer of an interest in land is not excluded from the scope of VAT by this definition. This is because the transfer of an interest in the land (i.e., a transfer of part of the total ownership of the land) is not the same as a transfer of the land. Instead, most kinds of transfers of interests, such as leases or rights to use land, are exempted under the VAT laws of many states. Short-term leases are subject to VAT. Works done on land, for example, civil engineering work or building work for the owner of land, are not excluded from the scope of VAT by this definition. Therefore, such works are usually subject to VAT.

The result of these definitions can be inconsistency between the VAT treatment of different transactions relating to land. Therefore, the VAT treatment of land needs careful consideration within the context of the landholding laws and practices of the state, with particular regard being given to the position of buildings sold by and to taxable persons for use in a business. For example, many states charge tax on a new industrial or commercial building, although not all those states charge tax on the sale of a building completed before the start of the tax in the state.[75]

D. Supplies of Services

---

[71] This applies in states that have adopted English land law.

[72] This applies in many civil law states. It also applies in states, such as those of the former Soviet Union, where land cannot be sold, but a building on the land can be sold.

[73] *See infra* ch. 7.

[74] *See id.*

[75] *See id.* for a further discussion.

A "supply of services" is often defined as any supply within the scope of VAT that is not a supply of goods or a supply of land.[76] This definition, when read with the definition of "supply of goods" means that *any* supply is within the scope of the charge to VAT. If that is so, it may be asked why there is any need to distinguish between "goods" and "services." The answer is that the rules locating a supply of services are different from those for a supply of goods, as are the rules determining when such supplies occur. Further, where VAT is charged at more than one rate, the precise identity of the supply may be critical. Also, the self-supply rules explained below apply to goods but not to services. Finally, a supply of goods across the frontier of a state is an import or export of those goods and is subject to the customs regime of the state. This does not apply to supplies of services. The latter point serves to emphasize that, in cases of doubt, it may be useful to consider the scope of the customs law of the state in considering whether or not something is a "good."

It is therefore not possible[77] to have a supply that is not either a supply of goods or a supply of services, except for supplies of land or money. From this, it is clear that "services" has an extended meaning. It covers the use of all forms of property and also transfers of the right to dispose of intangible property. It also covers negative events, such as refraining from activity or undertaking by covenant or agreement not to do something.[78] Indeed, "services" are supplied whenever value is added because of a transaction that falls within the scope of VAT. A transaction will fall within the scope of VAT under the normal rules if the transaction is a business transaction, if the person making the supply is a taxable person, and if some other person makes a payment for the supply.

VAT laws rarely offer a useful separate definition of "supply."[79] A supply will occur whenever there is some transaction or event involving a taxable person whereby the taxable person receives payment (or consideration) for the effects of that transaction or event. In other words, the concept of value added is reflected by this broad definition. Any narrower definition, and any attempt to place limits on the meaning of "supply" or of "services," would exclude economic activities from the scope of VAT.

---

[76] *Est considérée comme prestation de services toute prestation qui ne constitue pas la livraison d'un bien.*" CHE OTVA art. 6(1). In the European Union, "supply of services shall mean any transaction which does not constitute a supply of goods." EC Sixth VAT Directive, *supra* note 3, art. 6(1). Where goods are defined as excluding money, it is appropriate to provide that "services means anything which is not goods or money." *See* NZL GST § 2(1). The Japanese law has no equivalent and relies instead on a comprehensive list of kinds of service.

[77] Save by express provision. For example, the U.K. law provides that the transfer of an ongoing business is a supply, but of neither goods nor services. Special Provisions Order 1995, No. 1268, art. 5(1) (GBR), *reprinted in* Butterworths VAT Handbook 1995, at 451. This is a drafting device to remove that kind of transaction from the scope of VAT, but it does so in a way that defies the logic of the legislation of which it is part.

[78] For example, the EC Sixth VAT Directive includes in the definition of supplies of services "obligations to refrain from an act or to tolerate an act or situation." EC Sixth VAT Directive, *supra* note 3, art. 6(1).

[79] *See supra* the definitions quoted at notes 65 and 76. Some laws, such as the French, provide a series of examples of what is included in delivery and provision, FRA CGI arts. 256–59C; others refer to "transaction" instead. *See, e.g.,* BGR VAT art. 1.

Interpretation and application of this provision should reflect this broad policy approach because it ensures not only efficiency in collecting the tax but also fairness between one taxable person and another. It is only if all economic activities that add similar value are taxed similarly that a fair and easily administrable tax can exist.

Comment has already been made about the exclusion of land and money from the definition of supply of goods. If the above definitional structure for supply of services is used, it is necessary to repeat those exclusions in the definition of supply of services.

E. Supplies by Employees and Officeholders

The law should provide that the service undertaken by an employee for the employer of that employee does not form a supply made by that employee. Two ways of doing this are to expressly say so or to ensure that an employee can never be a taxable person, by providing that a person is a taxable person in respect only of supplies made by that person *independently.*[80] The rule also covers all those holding office, such as company directors and all government officers and employees.[81]

F. Supplies by Agents

Where a supplier supplies goods or services through an agent to another person, the supply is made not by the agent but by the supplier. Whether in a particular case an intermediary is an agent will depend on the precise legal nature of the contract between the persons involved. For example, an employee is the employer's agent. The employee's service, if supplied directly or indirectly to a third person, is a supply by the employer. This rule covers all supplies from employees, including the case where an employee works directly for some third person, if the third person contracts with, and pays, the employer. If the employee is seconded to the third person and is paid directly by that third person, then the true relationship may be that the employee is now employed by the third person. If the third person makes no payment to the employer, then the payment to the employee will probably not constitute consideration between the employer and the third person, so that there is nothing on which VAT is to be paid.

An agent is normally entitled to a fee or commission for services rendered to a supplier, and VAT is charged on those services (unless they are exempt). Where an agent is used, it is therefore for the supplier, not the agent, to charge VAT and to pay it to the budget. Special powers may be considered necessary to enforce payment of VAT by an agent where the agent, rather than the supplier, has the money to make payment and the supplier has not paid.

---

[80] See the definition of taxable person in EC Sixth VAT Directive, *supra* note 3, art. 4(1), on which this text is based. The reference is to "independent workers" rather than to "dependent workers."

[81] *See also* the discussion on employment status in connection with social security, *infra* ch. 11, and income tax, vol. 2, ch. 14.

One special case is that of a sale by auction, or other forms of sale where the agent does not reveal that there is an agency or declines to reveal the identity of the person for whom the agent is acting. Here, the supplier effectively remains unidentified. Therefore, it may not even be clear whether the supplier is or is not a taxable person. In such cases, it is necessary to treat the agent as a principal for the purposes of charging VAT to customers and to include rules requiring that this be the case, whatever the underlying legal relationships. The effect of this is to require the agent (if a taxable person) to issue invoices to the customer and for the principal (if a taxable person) to issue invoices to the agent for the items sold.

G. Mixed Supplies and Multiple Supplies

In practice, it is often difficult to identify the nature of a supply. Often what is supplied is a mixture of different things and often of both goods and services. For example, *A* agrees to sell some goods to *B* and also to deliver them to *B*. *A* also agrees to install them upon delivery. An engineer agrees to repair *B*'s broken machine and supplies some small spare parts while doing so. A club allows *B* to become a member and provides *B* with both goods (such as books and a special badge) and services (such as advice or the use of club premises) when *B* joins. In each of these cases, is there a single supply or more than one supply? Are the supplies of goods or of services?

States need to adopt simple practical rules for dealing with these everyday occurrences so that those making mixed supplies and multiple supplies can determine without excess difficulty how and when VAT is to be applied to each supply. One broad practical rule is to treat any supplies incidental to a main supply as part of that main supply. If, for example, *A* makes no separate charge for delivery, then the service of delivery is ignored, and the supply is taxed only as a supply of goods. If the engineer charges separately for the spare parts, then VAT should be applied separately to them. A multiple supply, such as club membership, may require that the one payment be apportioned between the different elements of club membership.

A simple broad VAT allows many of these problems to be avoided. If none of the forms of supply is exempt and all are subject to VAT at the same rate, then it is not as critical to separate the elements of a supply. When numerous categories of exemption are allowed and more than one rate of VAT is introduced, administration becomes more complicated because much closer attention must be given to this problem.

H. When a Supply of Goods Takes Place

The time of supply is important for deciding when a tax invoice has to be issued in respect of a supply, when tax is due in respect of a supply, the rate at which the tax is payable,[82] and in which taxable period a return has to be made in respect of that supply and in which any tax credit can be claimed by the person receiving the supply.

[82] In cases where the rate of tax has been changed from one period to the other.

The rules determining when a supply of goods takes place vary from one state to another[83] but generally a supply of goods takes place when

- a VAT invoice is issued for the supply,
- the goods are delivered,
- the goods are made available,
- the goods are removed or transported to or for the customer, or
- the goods are paid for in whole or in part.

In accounting terms, these rules include both a cash basis and an accrual basis for timing a transaction. In the interests of securing the cash-flow position of the state and of ensuring efficient collection of the VAT, it is usual to provide that the time of supply occurs when the first of these events occurs, or soon thereafter.[84]

Once a VAT system is established, it may be most efficient to provide that the primary rule governing time of supply is that the supply occurs at the time when the VAT invoice is issued, provided that the invoice is issued promptly. In practice, many suppliers issue tax invoices at the time of a supply or shortly thereafter to comply with the obligation to issue a timely invoice. The law could, for example, define the time limit as seven days after what would otherwise be the time of supply under the rules set forth above.

A supply of goods is defined as a transfer of the owner's right to dispose of tangible property, but the time of supply for the purposes of this law is fixed not by reference to that transfer, but by reference to the delivery of the goods themselves. Often, the transfer of the right will occur with the delivery of the goods, but this will depend on the precise provisions of the laws of the state relating to the sale of goods and supplies of other kinds.

Sometimes goods are not "delivered" in the usual meaning of the word. For example, a supplier sells to a customer an agreed quantity of a commodity, such as grain. The grain is held

[83] This applies for invoice-based and transaction-based approaches to VAT. If the VAT is levied on an accounts base (e.g., in Japan), the timing rules are the same or similar to those applying for corporation tax. *See* Ministry of Finance, *supra* note 4, at 172–74. This is often based on general accounting principles and therefore relates either to the cash transaction or to accrual.

[84] Special considerations may apply in some transition countries where there are serious problems of interenterprise arrears. *See generally* Summers & Sunley, *supra* note 9. Many of these countries operate VAT on a cash basis, or provide that the taxable event occurs at a specified time after the events referred to in the text. For example, in Georgia the taxable event occurs 90 days after the date that goods are shipped or services are performed. A complete discussion of the issues is beyond the scope of this chapter, but some general principles can be stated. First, it is critical that the rules for time of supply be identical for the output tax and input tax of a particular taxpayer. If a taxpayer is allowed to pay output tax on a cash basis, the taxpayer should not receive credit for input tax until the taxpayer makes payment for supplies. Second, as a general matter, to avoid claims of input tax in advance of output tax being paid, it is best to have a single rule that applies to all taxpayers, perhaps with limited exceptions, such as for small taxpayers.

in a store by the supplier, who releases the grain only when the customer sells it to a third person, to whom the supplier delivers the goods on demand from the store. In such a case, not only are the goods not delivered to the customer, but they are not appropriated to the customer either. Cases such as this could be dealt with in regulations. Those regulations might be based on the legal provisions of the state dealing with the transfer of ownership of goods in situations where the transfer does not involve delivery.

Where payment is made in advance of goods being delivered, the supply should be considered as taking place on the date of the payment to the extent of its amount. The aim is to ensure that the VAT liability arises as an advance payment is made and does not await any transfer or dealing with the goods. Otherwise, advance payments could be used as a means to avoid or delay the payment of VAT. This may happen, for example, where an advance payment is made, but no invoice is issued. If the goods are delivered, it may be said to be a loan for which no payment is claimed pending the more formal agreement. This more formal agreement never occurs, thus leaving the supplier with an advance payment that apparently does not relate to any supply and leaving the person supplied with the use of goods for perhaps a long period.

The reference in the preceding paragraph to a supply taking place to the extent of the amount of the payment implies that where only partial payment is made, portions of the amount of the supply will take place on different dates. A partial payment is treated as the first occasion of supply and the occasion for any further supplies is determined in accordance with the general rules. This rule will apply separately to the situation where two or more payments are made for a supply if separate invoices are issued in respect of each payment. If one invoice is issued for the full amount due, then this will represent the applicable date for the supply for the whole sum, although payment is made in installments.

Where the "supply" of goods is actually a series of supplies occurring on a number of separate occasions, then a taxable supply occurs on each separate occasion. This is equally true for a supply of services. For example, a customer may agree to buy from a supplier the right to set up a market stall on the supplier's land each Thursday throughout a year. A supply of the use of land in this way is a taxable supply of services. Is it one supply or a supply of the use of the land each Thursday? A technical answer to this question might refer to the precise terms of the contract under which the supplier agrees to supply the use of land in this way, including the method of payment adopted. Treating each date of supply as a separate supply achieves an efficient and practical result in that the supply is regarded as occurring each Thursday if payment is made for each week only after that week. If payment is made for the whole year at a set time before the end of the year, the rule about prior payment will apply. It is normally appropriate to apply the rules by reference to the terms of the agreement between the supplier and the customer. To avoid practical problems and to simplify administration, regulations can deal in detail with cases such as this.

J. When a Supply of Services Takes Place

The considerations set out as applying to the time when a supply of goods takes place also largely apply to a supply of services. However, services are not "delivered" or "appropriated" in the same way as goods. Instead, it is usual to determine the time of supply by reference to when the services have been rendered. This is a question of fact to be interpreted in the light of any contract or agreement under which the services are supplied.

A special case that may need a different rule is that of a supply of services over a long period or a continuing supply. If a supplier agrees to supply a customer with a continuing service (e.g., a telephone service, a supply of electricity, or continuing professional assistance), the supply might be regarded as never reaching the point at which it "is performed" until the contract between the supplier and the customer is ended, or it might be viewed as provided every minute, which would be impractical. However, payment is made from time to time, and the rule about partial payment can be applied. Alternatively, it may be that the contract between the supplier and the customer shows that the services are supplied, in effect, on a series of separate occasions. If so, it is usual to treat each supply as made when a partial payment for the supply is made or when an invoice is issued for that part. It may be that the "supply" is not one supply, but a series of supplies. If cases of difficulty arise under this general rule, special provision can be made through regulation.

K. Where a Supply of Goods Takes Place

The introduction to this chapter stressed that the VAT is usually based on the destination principle, that is, with goods being subject to VAT where they are either received or consumed. For this reason, goods crossing frontiers are subject to a regime similar to customs duties on arrival. Therefore, it is necessary to clarify where goods are received. In the case of imported goods, the adoption of customs laws will help deal with this problem. The VAT laws can adopt from the customs laws rules to determine when goods are imported and the nature of the goods imported.

In practice, most international supplies of goods are caught in this way by the customs laws of states. Location rules may also be useful within the state and to deal with exports. Often, a general rule is included in the law to locate a supply of goods where the goods are delivered or made available to the person supplied, in other words, where they are physically handed over. The fact that legal title does not pass at that time is not the important issue. For goods that are being transported, a rule is needed to determine whether they are delivered at the start or at the end of the transportation. A rule that goods are delivered where the transportation starts will accord with the common commercial arrangement that goods are at the risk of the buyer while being transported. It will also ensure that the location of the supply of goods being exported is within the state. That is necessary to provide a legal basis for providing a rebate of VAT on inputs used to produce those goods.

L. Where a Supply of Services Takes Place

Determining the location of a supply of services can be a matter of considerable difficulty, especially for international services. Customs rules cannot be used because they do not apply to services.

A second difficulty arises from the application of the destination principle. This provides that services should be taxed where they are received or consumed. However, consider, for example, the supply of legal services by a lawyer in one country to a person in another country. Where does that supply occur? The physical location of the supply may be both difficult to determine and irrelevant to the place where the supply is consumed. It might take place in the country of the lawyer, that of the client, in some third state, on an aircraft, over the telephone, or through e-mail originating in, or received in, a range of offices. If the law firm has offices in several states, the advice could be sent from any of those states. The underlying legal research, writing, and investigation could also be performed in a variety of places.

Behind those problems lies that of ensuring that a taxable person is within the jurisdiction of the state, so that the VAT can be enforced. This does not matter for imported goods, because in the last resort the goods themselves provide security for payment of the VAT. Equally, it is easy to identify a person who can be treated as importer, and duties may be imposed on that person. Another policy aspect is that fairness and neutrality require that services that originate overseas be taxed in the same way as services that originate in the state. Otherwise, overseas suppliers may be able to compete on unfair terms.

In the absence of any international agreement setting jurisdictional limits to VAT and any ready assistance in enforcing VAT in other states, there is no clear and universally accepted answer to the question of how to treat international services.[85]

Some aspects of the problem can be solved by identifying separate rules for particular kinds of supply. For example, where the services relate to land or other immovable property, it is common to treat the services as supplied where the land is situated.[86] This provides a rule consistent with usual rules on conflicts of laws, and also access to security. Similarly, a supply of transport services can be treated as occurring where the transport is supplied.[87]

[85] The EC adopted standard rules in 1977 but was unable to adopt a simple and universal rule. *See* EC Sixth VAT Directive, *supra* note 3. As will be noted further in the text, the main rule relates to the supplier's place of business, but there are four sets of exceptions to this, two of which are permissive rather than mandatory. As a result, the location rules within the EU member states are not entirely consistent.

[86] This is the rule for the European Union. EC Sixth VAT Directive, *supra* note 3, art. 9(2)(a). The New Zealand Goods and Services Tax Act taxes supplies of services to "goods" in New Zealand at the time of supply; this includes land. NZL GST § 8. The Swiss OTVA adopts the EU rules. CHE OTVA art. 12(2)(a). The South African Value-Added Tax Act achieves a similar result by zero rating supplies connected with land in another state. *See* ZAF VAT § 11(2)(f).

[87] International transport services are usually either exempted or zero rated, *see infra* sec. VII(C), but a jurisdictional rule is still needed. This rule is found in EC Sixth VAT Directive, *supra* note 3, art. 9(2)(b). The Swiss OTVA, art. 12(2)(b), makes similar provision, save that a discretion is reserved to the Swiss authorities to decide cases where only part of a journey is through Swiss territory.

Beyond this, states tend to adopt rules that locate a supply at a place of business either of the supplier or of the customer.[88] The practical problem about locating the supply where the customer is located is imposing the VAT on that supply. One answer to this is that of *reverse charging*. A reverse-charging rule treats the customer being supplied with a service originating abroad as making the supply to itself. It must then account to its tax authorities for the VAT due as output tax on that supply.[89] If the customer pays that VAT as input tax, it can claim an offsetting deduction, and will owe no VAT. However, if the customer makes exempt supplies, then no VAT credit or deduction is available.

M. Treatment of Imports

The destination principle requires a charge to VAT to be placed on all imports. This is usually done through a charging provision that parallels the one on internal supplies. The parallel provision normally adopts and adapts the laws imposing customs duties on the imported goods. The laws determining whether items are goods (inclusion in the tariff), whether they are imported (rules of origin), and when and where they are imported will serve for VAT purposes as for customs duty purposes, although it may be necessary to make clear that the act of importing occurs within the territory of the state for VAT purposes to avoid any legal problems.[90] Customs regimes, such as free ports, duty-free shops, and tax-free zones can be applied readily to VAT on this basis, the zones being regarded as outside the territory of the state.

IV. Taxable Supplies

A. Definition

[88]The primary rule in the European Union is that the service is supplied "where the supplier has established his business or has a fixed establishment . . . or . . . his permanent address or [where he] usually resides." EC Sixth VAT Directive, *supra* note 3, art. 9(1). The Swiss OTVA uses the same primary rule: OTVA art. 12(1). Does this amount to the same thing as a permanent establishment for direct tax purposes? In some cases, it will. The New Zealand approach is to base jurisdiction on the residence of the supplier. NZL GST § 8(2). However, unlike income tax, this is not subject to provisions about double residence.

[89] This is not the same thing as self-supply. Self-supply means that there is no supplier—the goods or services are consumed by the person producing them. Reverse charging applies where the person receiving the supply is deemed also to be the supplier so that a charge to VAT may be applied to it. *See* GBR VAT § 8 (from which the name "reverse charge" is taken).

[90] Normally, the customs law, or general law, of a state will provide that imported goods are within the state for procedural purposes. If any doubt arises about the extent of procedural or substantive VAT provisions in the absence of such laws or their clear application, a simple deeming provision will resolve doubts.

A "taxable supply" is a supply or transaction on which VAT is imposed.[91] When a taxable supply is made, the person making the supply, if a taxable person, must impose and collect VAT and account for it to the tax authorities. Even if the person does not do this, the tax authorities are still entitled to collect VAT from the taxable person on the assumption that the VAT had been imposed. On what supplies is VAT imposed? The law should impose it on all supplies of goods and services within the scope of VAT and made by a taxable person unless the law itself exempts the supply from VAT.

As previously noted, to be within the scope of VAT, a supply of goods and services must also be made (a) as part of the economic activities of the supplier, and (b) against payment (or for consideration) to that person from some other person. To complete the full definition of taxable supplies, the law must also therefore define both these criteria and determine the extent of exemption. Each of these issues is addressed in this section.

B. Economic Activities

VAT is a tax on supplies made in the course or furtherance of economic activity, or, put another way, as part of a business.[92] It should therefore be confined to activities of this nature and not be imposed on other activities, such as the personal hobbies of an individual,[93] gifts made for personal reasons, or charitable activities with no business or commercial content.[94] In

---

[91] This term is used in the laws of New Zealand, NZL GST § 2(1); South Africa, ZAF VAT, and the United Kingdom, GBR VAT § 4(2). Title V of the EC Sixth VAT Directive, *supra* note 3, refers to "taxable transactions," as do Hussey and Lubick in their draft, *supra* note 13, § 211. The French CGI avoids the term, referring to "*opérations obligatoirement imposables*," FRA CGI art. 256, and the French version of the Swiss OTVA follows this vocabulary. CHE OTVA § 1 (*Opérations imposables*). The term depends on whether it is appropriate to use "supply."

[92] The phrase "economic activity" is based on the EC Sixth VAT Directive, art. 4, *supra* note 3. This is chosen from the range described in this note because it is felt the term is best fitted to be translated widely. The scope of the term is wider than "business," in the sense that the term tends to imply only profitable activities. Profit is irrelevant to VAT (although the profit motive is not). Note, however, there are alternative approaches. The New Zealand Goods and Services Tax Act refers to "taxable activity." NZL GST § 6. The South African VAT Act refers to a supply "in the course or furtherance of any enterprise...." ZAF VAT § 7(1)(a). The Irish VAT Act applies to supplies "in the course or furtherance of any business...." IRL VAT § 2(1)(a). The United Kingdom VAT Act uses the term "in the course or furtherance of any business...." GBR VAT § 4(1). Hussey & Lubick, § 211(b)(2), *supra* note 13, uses the phrase "in connection with a business," as does the American Bar Association draft, *supra* note 11, § 4003(a)(1). From this it will be seen that the general approach described here is widely adopted, but that there is no standard vocabulary for it.

[93] The definition of a "hobby" or leisure activity is difficult because it depends at least in part on the subjective intentions of the individual undertaking the activity and will also vary with the cultural context in which the individual is operating. The New Zealand Act excludes any activity of an individual "carried on essentially as a private recreational pursuit or hobby...." NZL GST § 6(3)(a).

[94] For a discussion of the economic and legal rationales for the tax, *see* ch. 7 *infra*. This approach can lead to the exclusion of some personal consumption from the tax base. This may be justified primarily by administrative consideration, such as difficulties in allocating input credits where supplies are not made as part of a business.

practice, the separate criterion that a supply of goods and services must be made, or treated as made, for consideration (or against payment) serves to remove many nonbusiness activities from the scope of VAT.

The rule under which only supplies by taxable persons are within the scope of VAT has a similar effect of excluding many transactions by individuals. However, whether or not a person is a taxable person is defined by reference to the total activities of that person, so an independent definition of taxable supplies is needed. Another unclear area is that of the activities of public authorities. These may be economic activities but may also be exercises of sovereign power with no economic content (as against economic effect). Examples are the activities of the armed forces or the courts.

As a result, the law imposing the VAT usually makes it clear that only economic activities are within the scope of the tax. How this is defined varies among laws.[95] Some laws require that the supply be made as part of economic activity, or the business activities of the supplier, or in the course or furtherance of a business carried on by the supplier. Others refer to supplies made by the taxable person acting as such, that is, acting in the capacity as a taxable person making taxable supplies.[96]

Some laws offer definitions of these activities,[97] but such definitions often do not add much to the overall clarification of the scope of the law. This point will need separate consideration in individual states. The key point is that here as elsewhere the law must be interpreted and applied so that it catches all economic activity that is not deliberately excluded. Government activity, charitable activity, and personal nonbusiness activity should therefore be excluded. The extent to which this point needs to be spelled out in the law will depend on the ease with which the concept of economic activity or business activity is understood within the state.

---

[95] *See supra* note 91 (addressing the varied vocabulary and national practices).

[96] This is the key approach of the EC Sixth VAT Directive, *supra* note 3, in applying VAT to the supplies of a "taxable person *acting as such*...." *Id.* art. 2 (emphasis added). This reflects the French approach of subjecting to the tax those who make, *in an independent manner,* habitually or occasionally, one or more supplies on which the VAT is imposed. FRA CGI art. 256A (emphasis added). The Swiss OTVA adopts the same focus, applying the tax only to those persons who exercise *in independent manner* a commercial or professional activity with a view to realizing receipts. CHE OTVA art. 17 (emphasis added).

[97] *See, e.g.,* NZL GST § 6(1). The United Kingdom defines "business" by implied reference to its income tax laws, *see* GBR VAT § 94(1)(using the same language as GBR ICTA § 18 (the income tax charge on business activities)), and this approach, adjusted to the local laws, might be useful.

C. Payment for a Supply

A supply is made for payment, consideration, or compensation[98] if the taxable person making the supply receives, or is entitled to receive, payment for the supply.[99] For this purpose, it does not matter in what form the payment is made. An exchange of goods is a supply for payment or consideration by both parties to the bargain, as is a supply of goods in exchange for the provision of services by the person receiving the goods.[100] In addition, it does not matter who makes the payment. It will usually come from the person receiving the supply, but the source is irrelevant. Therefore, some laws make it clear that all forms of payment are to be included as payment or consideration for the supply, even if this includes grants made by public authorities or other third parties.[101]

The concept that a supply is within the scope of VAT only if there is payment or consideration for it follows from the fundamental nature of the tax as one imposed on the value added by a transaction. If a supply does not result in gain for the supplier, directly or indirectly, then no value is added in making the supply. By contrast, the same reasoning argues that the consideration should include all forms of payment received by the supplier, in cash or in kind, whenever and however paid, and regardless of who pays them.

This definition is usually used as the definition of the taxable value of the supply, that is, the amount on which the VAT is imposed. Both efficiency and fairness therefore argue for a comprehensive definition.

Liability for payment of VAT on a supply does not depend on the transaction complying with provisions of the contract law or commercial law of the state. The obligation arises, in the usual case, because as a matter of fact, a taxable person has made a supply and has received

---

[98] Compensation" sometimes carries the meaning of pay for employees, which is not intended here. The alternatives are provided because in a common law country the term "consideration" normally conveys a sense of the consideration required as part of the necessary elements of a contract between two parties. "Consideration" has a wider meaning than this in a VAT context, because it includes payments from third parties and payments made even when, for some technical reason, no contract has been created.

[99] Note the discussion at the text accompanying notes 25–28, *supra*, on the terms used here. The wording "payment" is preferred to "consideration" for the reasons already discussed. There is no consistent usage internationally.

[100] Except where the person supplying the services is an employee of the person supplying the goods, in which case the supply of the goods is treated as a supply, while the supply of services is not treated as a supply for purposes of VAT. *See supra* sec. III(D).

[101] The inclusion of public subsidies "directly linked to the price of ... supplies" is found in the EC Sixth VAT Directive, *supra* note 3, art. 11(A)(1)(a), but is not found in all the laws of the EU member states. Subsidies not linked to prices or to any specific service or goods produced by the person being subsidized will not be consideration or payment for any specific item and are therefore not within the scope of VAT. It is possible that some direct tax provisions might amount to subsidies within this provision, although the writer is not aware of any practical example of this. It might be considered preferable to exclude such possibilities from the VAT law by providing an exemption for subsidies.

payment for it. The legal obligation to supply or pay is not relevant at this level. It becomes relevant if no payment is received, although the supplier is entitled to receive it, because the timing rules of VAT, discussed above, generally impose liability to pay VAT whether or not payment has been made at the time the VAT is due. Failure to pay should require a subsequent revision of the overall VAT liability of the taxable person. This is discussed below.[102]

Of course, if *A* pays *B* to make a supply to *C*, it must be asked who is being supplied. Is it *A* or *C*? This will depend in part on the laws of contract of the state. However, the amount paid by *A* is payment or "consideration" for VAT purposes even if there is no contract between *A* and *B*.[103]

D. Transactions Where No Payment Is Payable

In principle, if there is nothing paid or payable for a supply, then it is not a taxable supply. Safeguards are needed to prevent the operation of this principle from allowing transactions to escape a charge to VAT in inappropriate situations. For example, a taxable person who makes gifts of goods acquired for the purpose of the person's economic activities should be brought within the scope of the tax. Likewise, an individual trader who personally uses goods purchased for the business should also be made subject to VAT on the use. The reason for this is that the trader will have received a VAT credit (or deduction for input tax) for the goods on purchase. If there is no offsetting output tax, then there is a hidden subsidy of the trader's personal consumption and gifts.

It is therefore wise to extend the definition of supply for consideration to cover certain nonbusiness uses of a supply. The following transactions or occasions should be considered for this purpose:

(a) personal consumption by an individual of goods purchased for the individual's business, including consumption by the individual's family and household;

(b) gifts of goods, or the use of goods, made by a taxable person where the goods were purchased solely for the person's business, and the gifts are not themselves for business purposes (e.g., advertising or trade samples); and

(c) supplies of goods made without charge to employees of the taxable person.

[102] *See infra* secs. VI(E), VII(L).

[103] This complication does not arise where states do not require "consideration" as part of a contract. It is another example of a concept that does not readily translate between languages and law systems.

For example, a shopkeeper who purchases food as part of her or his business but later uses the food for personal consumption might be obtaining an unfair advantage. The shopkeeper will treat the purchase of the food as a supply on which any VAT paid can be reclaimed. When the shopkeeper consumes the food, if there is no charge to VAT, the shopkeeper will have been able to obtain a credit without any charge of tax to someone else. It is appropriate to provide that the supply or use of goods in this way is taxable. The shopkeeper will therefore have to account to the tax authorities for the value of the goods consumed as if they had been sold. At a minimum, the effect is to prevent excess tax credits from being given.

This rule will apply equally to the use of durable goods. For example, where the shopkeeper uses partly for private purposes a car that is regarded as purchased as a business asset, there should be an appropriate adjustment in the accounts of the shopkeeper to reflect this. It may be desirable to provide more detail of how such accounting should take place by regulation.

These rules usually apply to supplies of goods but not to supplies of services.[104] This is deliberate and is intended to stop any attempt to tax, for example, the situation where a builder repairs part of the builder's own home or a professional person applies part of her or his professional expertise to her or his own benefit. Attempts to tax such events will prove impracticable and may be potentially unfair, because the events may be part of the private activities of the individual and often do not involve any claim for tax credits. If goods are used as part of a supply of services (e.g., by a builder), then the rule should apply to the goods unless, as a practical matter, the goods are incidental to the services.

A rule that imposes VAT on a supply for which there is no consideration must also provide a taxable value to that supply. Alternative measures for determining that value are considered below.[105]

The general rule is sometimes made subject to an exception for advertising, trade samples, and trade use. A business may make gifts of goods it supplies, or make available free use of those goods, to customers as part of the business without consideration in such a way that the expense of providing the goods or the use of the goods is properly regarded as a business expense. This exception is designed to protect those practices from being subject to VAT if it is considered inappropriate to impose a charge on these gifts. It is for the tax authorities to consider whether more detailed guidance is needed to ensure that this provision is used appropriately, but not abused, by taxable persons.

E. Supplies Where Payment Is Not Full

---

[104] This is another example where the theoretical tax base (consumption) does not correspond with the legal tax base as typically defined. *See* ch. 7 *infra.*

[105] *See infra* sec. VI(D).

Together with transactions for which no payment is made, but where it is deemed to be made, mention must be made of supplies where the payment made is less than the full payment or consideration that should, or might, be paid in the open market. If some payment is made, then the supply is within the scope of VAT. However, a partial payment is not itself a proper measure of the value added by the supply, and an alternative measure of that value added is needed. This was addressed previously.[106]

V. Exempt Supplies

A. General Comments

All states have found it necessary, when introducing a VAT, to create exceptions to the breadth of the potential scope of the operation of VAT. The standard way of dealing with this is to exempt certain forms of supply that are otherwise within the scope of VAT from liability to VAT.[107] By definition, exempt supplies are not taxable supplies.[108] By contrast, some states have adopted the practice of listing those supplies that are subject to VAT, rather than adopting the approach here.[109]

State practice on the exemption of supplies is inconsistent. Few common themes emerge. When VAT was first introduced, it was more common than it is now to apply VAT to supplies at

---

[106] *See supra* sec. III(H).

[107] This pattern applies throughout the European Union under the EC Sixth VAT Directive, *supra* note 3, Title X. It is also the pattern explicitly adopted by New Zealand, NZL GST § 14, and the countries that followed the New Zealand approach of minimizing exemptions. *E.g.,* CAN GST § 123(1) (definitions of supply, taxable supply, exempt supply). The French CGI approach is similar, first stating the taxable transactions in broad terms, then listing the exemptions. FRA CGI arts. 256, 261; *see also* CHE OTVA arts. 4, 14 (first, setting forth the taxable transactions in a short, broad form, and then setting forth the exceptions).

[108] The terms "exempt supply" or "exempt transaction" are widely used in English-language texts. *See, e.g.,* EC Sixth VAT Directive, *supra* note 3, Title X ("exemptions"); IRL VAT, §§ 1(1), 6 ("exempt activities"); NZL GST § 14 ("exempt supplies"); South Africa, ZAF VAT § 12 ("exempt supplies"); GBR VAT § 31 ("exempt supplies"); *cf.* Hussey & Lubick, *supra* note 13, § 211(c)("exempt transactions"). The French approach is the same, the equivalent term being "*opérations exonérées*." FRA CGI art. 261. This stands in contrast with the Swiss approach in the OTVA, where the exemptions are stated as operations outside or excluded from the scope of the tax. CHE OTVA art. 14. This drafting approach therefore limits the scope of the tax, rather than carving out areas of exclusion within it. It is the main difference between the Swiss VAT and that of the EU states that surround it.

[109] For example, Argentina. ARG IVA art. 3. The VAT law in the People's Republic of China is also limited in scope, *see* CHN VAT art. 16 (items exempt from VAT), but this is because the VAT is deliberately not intended to have the universal coverage assumed in this chapter. Save where the intention is to limit the tax (not the approach adopted in this chapter or in most states), the approach adopted in the chapter is to be preferred to the alternative. This is because the approach of listing in some detail the kinds of transactions taxed inevitably means that any new kind of transaction or any transaction not specifically considered falls outside, rather than within, the scope of VAT. This renders the structure of the tax more open to the activities of those who plan to avoid tax and who will seek to identify and exploit the gaps in the list. A specific list of exemptions means that the "gaps" are deliberate.

a range of rates, including very low rates, and also to exempt a wide range of supplies. Since then, state practice has tended to reduce the range of supplies exempted and also to cut down the range of reduced rates of VAT and to increase the levels of the lowest rates.

Broad policy considerations, including ease of administration, the revenue levels produced by VAT compared with other taxes, the trade-off between the rate structure of VAT and the base on which those rates are levied (the broader the base, the lower the rates), fairness, and economic neutrality of the tax, all argue for minimal use of exemptions.[110] Political considerations in individual states and, in particular, the political perception of social considerations have been used to argue to introduce or preserve exemptions. An additional consideration to a newly introduced tax is that it is easier to introduce a broad-based VAT when the tax is first operated than to attempt to remove exemptions once established.[111]followed in Singapore. *See* SGP GST.

A few states have distorted the VAT framework even further by allowing zero rating of internal supplies.[112] As discussed below,[113] zero rating of exports and international supplies is very common. It is justified by the destination principle on which international transactions are subject to VAT. This does not apply to internal supplies. Zero rating may also be described as "exemption with credit," which is why it is mentioned here. To keep the discussion of exemption separate from the complication of zero rating, comment on zero rating is limited to the section on rates of VAT.

[110] *See generally* Tait, *supra* note 2, ch. 3.

[111] This was not true when the first VAT laws were introduced and when the EC first adopted VAT. New Zealand, in 1977, was the first state to adopt a form of VAT (deliberately named Goods and Services Tax to avoid comparison with the British VAT) with minimal exemptions. The New Zealand example has been

[112] The main state to do this is the United Kingdom. GBR VAT § 30. The extent to which zero rating was and is permissible under EU law has long been a matter of dispute. *See, e.g.,* Case 416/85, European Commission v. United Kingdom, 1988 E.C.R. 3127 (where the EC Commission successfully challenged several categories of supplies previously zero rated by the United Kingdom—in particular, many supplies of land and buildings). *See also* NZL GST § 11. Ireland also zero rates some categories of internal supplies. IRL VAT Second Schedule. In addition to exports, Italy zero rates certain supplies assimilated to exports, for example, supplies of airplanes to airlines engaged primarily in international transport. *See* ITA IVA art. 8 *bis*.

[113] *See infra* sec. VII(D).

B. Effect of Exemptions

It is often assumed that "exemption" results in the reduction of the VAT burden on a supply. This is true if the person supplied is a consumer and is not receiving the supply as part of a business. It is not true if the person supplied is a taxable person. Exemption of a supply to a business results in an *increase* in the burden of VAT on the supply. The reason for this is that the person running the business can offset the VAT against the VAT charged by the business, so claiming a full rebate for any VAT. The person making the exempt supply will probably have had to pay VAT on some part of the supplies made to it and will therefore have to pass some VAT on to the business as part of its price. It is this VAT that can be recovered if the supply is subject to tax, but that cannot be recovered if it is exempt. To avoid the distortions caused by this failure to recover, it is good policy not to exempt the types of supply that are typically made to business.

C. Specific Exemptions: Internal Supplies

Although there are strong policy arguments for minimizing exemptions, no state has succeeded in removing all exemptions from the law. Even New Zealand, which has been most successful in curbing the extent of exemptions, has maintained some.[114]

1. Land and Buildings

Transactions involving land and buildings are commonly exempted. As previously noted, many states provide that a sale of land, or other transfer of the title to land, is outside the scope of VAT. Other states achieve the same effect by exempting these supplies. Further, the law needs to deal with supplies of services related to land. The main service is the use of land, or leases or tenancies of land. For the same reason that land itself is exempted, it is common to find that leases and lettings of land are also exempted.[115]

At the same time, there is no strong reason for exempting commercial uses of immovable property, such as accommodation in a hotel. Accordingly, states restrict the extent to which leases, licenses, and tenancies are exempt. This may be done by excluding categories of land use (such as holiday use) from the exemption or by setting a minimum time period for exempt leases and tenancies (perhaps two months).[116]

---

[114] The New Zealand exemptions are (in summary) financial services, certain supplies by nonprofit bodies, certain supplies of accommodation and land, and supplies of gold and fine metals. NZL GST § 14. *Cf.* SGP GST 4th Schedule (under which the only major exemptions are financial services and certain residential real estate transactions).

[115] *See infra* ch. 7.

[116] *See, e.g.,* the extent of the exemption and the exceptions from it, in the EC Sixth VAT Directive, *supra* note 3, art. 13B(b). This approach has been widely adopted.

2. Supplies by Nonprofit Organizations and Individuals

Many states provide exemptions for social goods and services, that is, supplies that are made to individuals and that do not form, or do not usually form, business supplies. An example of this is the supply of health services that are by their nature supplied to individuals. Many social supplies are outside the scope of VAT because they are not made as part of a business or are not made for payment or consideration (as with free health supplies from a state authority). The only supplies that fall within the scope of an exemption are those that would, but for exemption, be within the scope of VAT. A compromise recommended in this context is to exempt social activities of nonprofit organizations[117] and also of individuals providing supplies in similar circumstances to these organizations. If a charity provides hospital treatment or a religious organization provides education for a nominal fee, this can be exempted.

Similar activities carried out by an ordinary commercial organization will not be exempt. As a result, nonprofit bodies may be tempted to engage in commercial activities in such a way as to gain unfair advantage over ordinary suppliers. It is not enough to justify exemption that those profits are used by the organization for nonprofit purposes. For example, a religious organization that runs profit-making shops to help finance repairs to a religious building should be subject to VAT on the goods it sells. A distinction must accordingly be drawn between the social or charitable activities of nonprofit bodies and their commercial activities.[118]

3. Financial Services

Exemptions of financial services[119] are also included to avoid problems of complex administration, for example, where it is difficult to identify the value added within a transaction. In principle, any fee or charge for a financial service should be liable to tax. The difficulty is in identifying that charge separately from the other elements that are included when determining levels of payments of interest or fees. Those other elements include the real cost of the capital

---

[117] This requires a definition of "nonprofit" organization or body. However, such definitions will usually be needed for income tax and for general legal purposes, so these may be used for VAT also.

[118] This is similar to the approach usually taken in an income tax. *See* vol. 2, ch. 19. The distinction is difficult to draw in many instances. For example, is a book-publishing activity carried on by a church or educational institution charitable or commercial in nature? A relevant criterion is whether treating an activity as exempt would distort competition with commercial activity.

[119] The exemption is usually focused on primary financial services, that is, services supplied direct by banks and finance houses. Definitions of services exempt under this category usually take the form of a list. *See, e.g.,* EC Sixth VAT Directive, *supra* note 3, art. 13B(d)(which has been followed by the Swiss OTVA art. 14(15) and in several other European states); NZL GST § 3 (followed in ZAF VAT § 2). The phrase "primary financial services" is not a formal phrase, but is intended to emphasize that it is the primary or core financial services, not all services connected with finance, that are exempted. One test is whether the supplier of the service is at risk. For example, the supplier of loan credits or banking services is at risk of loss because of the services. A provider of advice about where to borrow money or what banking services to use is not at risk. The exemption is normally considered relevant to the former category only.

involved, the risk to the lender of undertaking the transaction, and the inflation rate operative during the transaction. Transactions involving these elements may be termed primary financial services, and nearly every state exempts these forms of financial services for this reason.[120]included is the difference between the interest rate that, for example, a bank charges its customer and the interest it pays the people that lend to it. *See* Tait, *supra* note 2, at 92. Russia is the only state to have applied VAT to any form of primary financial service. The European Union has been considering restrictions on its broad exemptions.

D. Using Alternative Taxes

The exclusion of categories of supply from the scope of VAT, or the exemption of those categories, does not mean that those supplies need be excluded from all indirect taxation. Some examples may be given of this practice. It is noticeable that states, finding it less practicable to impose a VAT on forms of internal and international supply, are increasingly adopting other taxes to make good the revenue loss.

Examples of internal supplies taxed in this way are taxation of transactions involving land and buildings by imposing stamp duties or transaction taxes or high registration fees on the documents used for the transfers; exemption of insurance services, but the imposition instead of taxes on insurance policies or premiums; use of income taxes and other direct taxes to ensure taxation of payments for financial services (particularly interest) in place of the almost universal exemption from VAT of those services; exemption from VAT for betting and gaming, offset by specific taxes on those activities; exemption of activities where there is a state monopoly (e.g., postal services and some transport services), with fiscal adjustments to prices being used to the same effect.

Examples also occur of taxes being imposed on those international supplies that are exempted or zero rated by reason of the destination principle or pressures of competition. An increasingly common example is taxation of airports and airline tickets. Another is tourist taxes of various kinds, such as exit taxes when tourists leave the state. Further discussion of this topic is beyond the scope of this chapter.

E. Exemption of Diplomatic Activities

States generally have accepted treaty obligations to exempt certain supplies or imports as part of the recognition of diplomatic and consular immunities and of similar immunities for

[120] Several states have considered the taxation of financial services in detail, including New Zealand, Canada, and the United States, but found themselves unable to resolve satisfactorily the practical and conceptual problems raised by this charge to tax. There is an unresolved disagreement between experts about whether, and to what extent, interest should be subject to VAT. It is argued by some that the whole interest should be included in the potential charge to VAT. Others argue that the only amount that should be

international organizations.[121] These involve immunity from taxation for the embassies and consulates and for the recognized diplomats and consuls. These immunities are normally operated on a reciprocal basis and are based on the provisions of the international conventions that set out the required immunity from taxation.

In many states, no express provision is included in the VAT law on this matter, because the exemption is provided under the terms of international obligations that are part of national law. If such obligations are not self-executing in a particular country, or if the country wishes to clarify or expand on the exemptions accorded, a specific exemption needs to be provided in the VAT law.

F. Exempt Imports

International practice recognizes agreed categories of goods that are exempted from customs duty on import. Practice on this is well established and ranges from the import of a limited quantity of goods bought duty free in other states to exemption of gifts to charities or similar organizations. It is for consideration how far those exemptions should also apply for VAT purposes. Some are appropriate because of the underlying reason for the exemption from customs duty. Others would not be appropriate because they would create unfair competition with those supplying similar goods from within the state.[122] Principles of fairness and efficiency argue for minimal exemption from VAT even where customs duty exemptions apply, particularly if there is a business purpose behind the import. Whatever the policy adopted, it is convenient in most cases to frame the VAT exemptions on imports with the customs duty exemptions in mind, so as to avoid unnecessary inconsistencies.

One particular category of import has caused particular concern in developing states and the economies in transition. This is the import of foreign-produced machinery and equipment for the use of local businesses. In principle, such items should be subject to VAT when imported, if also subject to VAT when produced locally. In some states, there is no local capacity to produce such items, and importers lobby strongly for VAT exemption. The imposition of VAT would not be much of a problem for taxpayers if a credit for the tax were immediately allowed, but there are often restrictions on such credits (e.g., a delayed credit for capital goods, a requirement to carry over excess credits, or a de facto difficulty in obtaining refunds). If an exemption is granted for pragmatic reasons, it should be restricted in scope and time and conditional on the genuine business use of the equipment.

G. Problems Caused by Exempt Supplies

[121] The main treaties are the Vienna Convention on Diplomatic Relations, Apr. 18, 1961; the Vienna Convention on Consular Relations, Apr. 24, 1963; and the agreements and conventions relating to individual international organizations. The exemption often takes the form of zero rating. *See infra* sec. VII(D).

[122] For example, an exemption on the import of manufactured goods will distort competition with any similar goods produced internally unless they are also exempt. There are, however, only limited circumstances in which it may be appropriate to exempt the domestic production of manufactured goods.

While, as discussed above, for both political and technical reasons it may be necessary to exempt a number of different types of supplies, exemptions create significant distortions beyond those that may be obvious (i.e., the fact that certain supplies to final consumers are favored over others). One of these distortions—the problem of exempt supplies made to businesses that are VAT taxpayers—has already been discussed above.[123] Another important problem is that of input credits to a business that makes both taxable and exempt supplies.[124] That problem involves the conceptual and practical difficulty of determining which inputs are attributable to exempt supplies. Inputs to exempt supplies cause an additional problem; namely, they create an incentive for a person making exempt supplies to supply itself through its own employees, instead of purchasing inputs from others. For example, a bank whose supplies are entirely or largely exempt financial services may enter into a contract with a security company to provide security guards. The security company will charge VAT to the bank if it is a taxable person, and the bank will be unable to recover the VAT as an imput credit.[125] The bank would have an incentive to hire security guards as its own employees. Because employee services are outside the VAT, this maneuver quite legally minimizes the bank's tax costs. In response, some states have imposed VAT in certain cases of self-supply by taxpayers.[126] However, antiabuse rules of this kind are of necessity limited in scope and cannot be generalized unless the VAT is fundamentally restructured (such as by treating all employee services as taxable). In addition to such legal avoidance, exemption leads to temptation for evasion: while normally businesses do not have an incentive to avoid VAT on their supplies (except as part of a scheme of tax evasion that would also involve the understatement of sales), a person making exempt supplies has an incentive to pay its suppliers under the table.[127] Widespread exemptions can therefore undermine the integrity of the VAT as a whole. This is a consequence of the invoice-credit method of VAT. The method works reasonably well if all supplies are taxable, but starts to break down when some supplies in a chain are exempt.

VI. Taxable Value of Supplies

A. Charge to VAT

[123] *See supra* sec. V(B).

[124] *See infra* sec. VII(G).

[125] *See Id.*

[126] *See* GBR VAT sec. 5; The Value Added Tax (Self-Supply of Construction Services) Order 1989, now SI 472, *reprinted in* Butterworths VAT Handbook 1995 at 381. The order treats a taxable person who constructs a building for use in the taxable person's business as making a supply to itself. This will give rise to tax liability only if the person is not able to claim a full input credit for the supply.

[127] For example, in Georgia restoration work on churches is exempt. A contractor hired to restore a church has an incentive to pay its suppliers under the table. If the contractor paid VAT on its supplies, it could not recover the VAT as an input credit.

VAT is designed as a tax levied as a proportion of the value added on any taxable supply. It is therefore necessary to attribute a value (referred to as "the value"[128]) to all taxable supplies to ensure that this objective is achieved. To be consistent with the fundamental principles of the tax, the value to be taxed must reflect the value added by the supply.

B. Value of Internal Supplies

The general rule for valuing a supply for VAT purposes is to value it at the total of all payments, or consideration, that the supplier receives or is entitled to receive as a result of the supply. In other words, the value is taken as the actual realized value. This relates to the requirement, already discussed, that there be payment for a supply in most cases for it to be within the scope of VAT. All forms of payment or consideration, whether paid by the person supplied or some other person, are relevant for that purpose. They are also relevant in determining the total value.

For the purposes of the general rule, it is irrelevant whether the total payment represents a "good" or a "bad" price for the supply, as long as it is a genuine price and not a sham. It is common to find rules that displace the price paid in certain cases, but in most commercial transactions it is a matter of indifference to the tax authorities if the price is "too" high or low. This is because any distortion of the price is neutralized if both the supplier and the person supplied are fully taxable persons. Any increase or decrease in the VAT collected will then be offset by a similar increase or decrease in the VAT credit or input tax deduction claimed. The matter is only of concern if the high or low price increases the overall amount of input tax available for deduction or decreases the overall collection of output tax. This will happen only where one party is a taxable person and the other is not.

C. Tax Inclusive vs. Exclusive Base

The value of a supply should be taken as including all other taxes paid on that supply. VAT is not an alternative form of excise tax or customs duty, but is a separate tax. Both customs duties and excise taxes reflect the state's separate decisions to increase the price of the dutiable and excisable products by the amount of the duty or tax. That represents the value of final consumption of the goods for VAT purposes and is therefore the basis of the value for VAT.

If it is felt that the combined effect of excise duty and VAT on a product is too high, the answer lies in adjusting the level of excise duty, not of the VAT. This is not only consistent with principle, but is also both simpler to administer and less distortionary. The alternatives would

---

[128] “Value" is the simplest English term (and is used, for example, in New Zealand, NZL GST § 4, and the United Kingdom, GBR VAT § 19), although "taxable amount" is also used in the Basic World Tax Code, Hussey & Lubick, *supra* note 13, § 221. As the tax is a "value-added" tax, it seems most appropriate to reflect the core wording here. The term "taxable value" is another option but is not used here because it merely adds to the length of the law without assisting understanding. The French CGI uses "base d'imposition," art. 266, and the Swiss (French) OTVA refers to *base de calcul*. CHE OTVA art. 26.

either be to exempt the items from VAT if subject to duty or to calculate the VAT on the price without counting the duty. Both would add significantly to the overall administrative burden on suppliers and the tax authority for no fiscal purpose.

One proviso to the general rule is needed. The law should state that the value does not include the VAT itself. Otherwise, a circular element is introduced into the calculation. The amount paid by the customer for a supply may be defined as including or excluding the VAT. For example, the price may be stated as "100." In some states, it is assumed in such a case that the VAT is to be added to that price, so that the full amount paid by the customer is 100 plus VAT.[129] In other states the assumption is the reverse of this, namely, that if the price is stated as "100," then that is the total that the customer is obliged to pay, including VAT.[130] In the first case, the value of the supply is, as defined above, 100. In the second case, the value *plus the VAT* is 100. For example, if the rate of VAT is 10 percent, then in this case the value is 90.9, and the VAT payable is 9.1 (rounded to the nearest decimal point).

The decision whether to include or exclude the VAT in determining the relationship between the value and the total consideration will need to be taken into account in framing the VAT law. However, it is a rule that belongs to the commercial law or consumer law of the state, not the VAT law. Any measure penalizing the exploitation of the rule to overcharge customers also belongs in a law other than the VAT law.

D. Fair Market Value of Supply

Where the person supplied is not a taxable person, or not a fully taxable person, but the supplier is a fully taxable person in respect of the supply, there may be a temptation for taxpayers to understate the price to avoid creating input tax that the person supplied cannot reclaim. There are also cases[131] where a supply is treated as being made for payment, even though nothing is paid or payable. In both cases, it may be considered appropriate to override the general rule.[132] Instead, value would be based on an independent measure of the value added by the transaction. This would normally be the open market price, or arm's-length price, of the supply. Again, clear rules will be needed to apply an alternative basis of valuation.

Temptation to adjust prices may also arise in the case of mixed supplies or supplies where a number of different parties are involved. For example, where a taxable person is acting on behalf of someone else, those transactions undertaken as agent for the other person may not

[129] This is the standard approach taken with regard to sales taxes in the United States.

[130] This is the standard approach taken in Europe.

[131] *See supra* sec. IV(D).

[132] This is a common, but not universal, practice. For example, in Japan there is no power to override the value determined by the parties. Instead, the Japanese tax authorities may use the "substantial attribution" rule (in CLT art. 13) to attribute the value to the person who is in substance, rather than in form, receiving it. *See supra* note 54.

be subject to VAT because the principal is not a taxable person. Here, close attention needs to be paid to ensuring that the total payment is shared properly between the different parts of the total transaction. This does not require the *total* payment to be altered. Rather it calls for careful auditing.

The open market price—or some other objectively determined price—will need to be determined in any case where a supply is treated as made for consideration although no consideration is actually paid or payable. It will also be needed in any other case where the law allows the tax authorities to override or ignore the actual price.

Put at its broadest, the power to override may be justified in any case where the relationship between the supplier and the person supplied is such that the price fixed between them may be open to pressures other than market pressures and where one or both parties are not fully taxable persons in respect of the supply. This will, for instance, include transactions between related persons. More generally, this issue can be addressed through legislative provisions similar to those found in income tax law (and customs law).[133]

E. Adjustments and Rebates

The rules to determine value need to be simple and easy to apply at the moment of sale, without delay or difficulty. They are applied in millions of transactions by everyone actually making supplies and fixing prices. Save for specifically documented adjustments, the person making the sale or supply must be able to determine what figures to put on the VAT invoice at that time without any need to revise them.

The rules determining value must therefore deal clearly with any adjustments, such as discounts, made to prices. For example, if goods are
sold as "normally 100, but 90 for today only," what is the price? The answer is that today the price is 90, that is, the value actually added by the transaction. However, tomorrow, it is 100, unless the lower price is actually agreed upon. For this reason, the value should be the price after any discounts.

The position is more difficult if the price for a sale is "100, but only 95 if you pay within seven days." In this case, the customer might pay either 95 or 100, and the supplier does not know at the time of sale. Here, the usual practice is to take the lower price, which is all that the customer needs to pay. The extra 5 might be regarded as a fee for late payment (and as such might be regarded as payment for an exempt financial service). Another complication is the use of vouchers or tokens. For example, a person buys an item at a shop and pays the full price, but also receives a voucher good for a reduction of 10 in the price on purchase of a second item. The sale of the second item will then be discounted to this person, even though others pay the full

[133] This topic, together with the problems of definition within it (such as the problem of defining a market price), is of considerable concern in the income tax. It links, in particular, to the problem of transfer pricing. This topic receives thorough discussion elsewhere (*see* vol. 2, ch. 18) and is not covered further here.

price. The value added, in the case of the sale to this person, is always the discounted price. This is both consistent with the principles of the tax and the most practical answer.

Further complications arise where the effect of a discount, or an arrangement on purchase, results in a later adjustment. In this case, no account should be taken of the change in connection with the first transaction. This should be dealt with as a separate transaction and treated in the same way for administrative reasons as a separate supply, even if the supplier pays money to the person supplied and therefore reduces the net consideration. When the adjustment occurs, the VAT should be added, or rebated, in exactly the same way as on the original supply. It is important from the point of view of the tax administration that there be no reason to alter the VAT invoice issued in connection with a transaction. Once the VAT invoice is issued, there should be no provision allowing for its alteration, except for the correction of an error. For example, if a customer pays $1,000 and an invoice is issued for $100, then a corrected invoice should be issued upon discovery of the mistake.

F. Value of Imports

In the special case of imports of goods, it is standard practice to use the customs value of goods as the value for VAT, subject to specific adjustments. The "customs value" generally represents an internationally agreed upon approach to the valuation of goods subject to customs duty and therefore minimizes the scope for difficulty or dispute in levying VAT on the import. It also simplifies the operation of VAT on imported goods and allows the VAT to be calculated at the same time as the customs duty and by the same officials. The customs approach may also be used when fixing the value for VAT of goods exempted from customs duty but liable to VAT. Attention has already been drawn to the advisability of aligning as far as appropriate the VAT exemptions on imports with the exemptions that apply under the customs code.

Two standard adjustments are needed to convert the customs value of goods to the value for VAT. First, consistent with the policy discussed previously on internal supplies, the value for VAT should include the customs duty itself. Excises levied on imports should likewise be added to the VAT base. Second, the customs duty will usually include all freight and handling charges and similar costs to bring the goods into customs control. The obligation on the person delivering the goods to the state may include further charges and the cost of inland freight to the place of delivery within the state. If the goods are not handed over at the time or place of customs clearance, then the value for VAT should include all additional freighting and other charges incurred up to the time of delivery to the customer. This is, again, consistent with the approach taken on internal supplies. If these extra charges are separate, then they may need to be dealt with as separate supplies.

VII. Payment of VAT

A. Determining the Amount to Be Paid

Two important elements remain in order to establish how much VAT the taxable person must pay to the tax authorities. The first is the rate of VAT to be paid on the value of any supply. This, together with issues already discussed, deals completely with the question of determining the output tax on any supply. The second is the offset of input tax against output tax to identify the net VAT payable. These topics, and associated issues, are discussed in this section.

B. Rates of VAT

Countries' practices in setting the rate or rates of VAT have varied widely over the forty years since the tax was first introduced. Some countries have imposed six or more effective rates at the same time. The result has been some confusion as to the purpose of the tax and considerable administrative complexity and market distortion. Recognition of these problems, and of the underlying policy issues, has led states to abandon complex rate structures. A detailed discussion of the relevant policy issues is beyond the scope of this chapter.[134] However, recent practice may be noted, and best practice commended.

It is now generally accepted that the VAT should not be used as a vehicle for imposing luxury rates of indirect tax.[135] If a state wishes to impose high rates of indirect tax on specific goods or services, then the generally easier way to do so is with a separate excise duty or tax.[136] This is the usual route now chosen. Internally, it simplifies the identification of luxury goods. Internationally, it avoids any accusation that differential rates of VAT are being used for discriminatory purposes.

It follows from this that VAT will have a main or basic rate and one or more lower rates. The main rate of VAT is an important matter of fiscal policy in any state and the level varies significantly among states.[137]

---

[134] *See* Tait, *supra* note 2, ch. 2.

[135] This is expressly excluded within the European Union. EC Sixth VAT Directive, *supra* note 3, art. 12. Several EU states that used to impose luxury rates of VAT have therefore withdrawn them. Some African countries still use luxury rates (in some cases first introduced following the French example, although France itself has since adopted the EU rules). An interesting example of a VAT-style tax being expressly geared at luxury items is the Wholesale and Luxury Tax in Venezuela. VEN IC. The VEN IC is levied at a standard rate and at two additional luxury rates. *Id.* arts. 56–58. The additional rates are applied to items such as cars, tobacco, jewelry, and cable TV. *Id.* arts. 57–58.

[136] In making such a decision, however, one would have to bear in mind the manufacturing process for the goods in question and, accordingly, the suitability of excise administrative procedures compared with procedures under the VAT.

[137] The European Union has agreed upon a minimum main rate of 15 percent, and rates vary from that to 25 percent in Europe. EC Sixth VAT Directive, *supra* note 3, art. 12(3)(a); OECD, Consumption Tax Trends 16 (1995). Elsewhere, countries with very broad forms of VAT can afford lower rates (such as New Zealand, NZL GST § 8(1)(rate of 12.5 percent)), while states under fiscal pressure have had rates of 30 percent or above. Tait, *supra* note 2, at 40.

Clearly, the higher the main rate, the more pressure there will be from lobby groups to apply one or more lower rates to specific items. In practice, it should be remembered that no long-term social objective is achieved by setting any rate other than the main rate on goods or services supplied to fully taxable persons. There may be a cash-flow advantage to them in not having to pay quite so much VAT before making a claim for the VAT credit for deductible input tax, but in the longer run the VAT they pay is reclaimed against their own output tax as a VAT credit for input tax and thus has no residual effect.

Arguments for lower rates therefore concentrate on socially important goods such as food, and socially important services that are not exempted or outside the scope of VAT. Of course, there is a cost in VAT forgone in allowing a lower rate, and any lower rate will usually cause either the main rate of VAT to be higher than it otherwise would be, or other taxes to be higher, given the total tax revenue. Some states have decided that it is better to collect VAT at one rate and to deal with such pressures in other ways (through subsidies or adjustments in social security entitlements), while others have opted for a lower rate. Again, practice used to involve a range of lower rates but has tended to simplify toward one lower rate (as is happening within the European Union) or none.

C. Zero Rate

In addition to the main rate of VAT and any lower rates, it is normal practice for states to have a zero rate of tax, although it may not be called this.[138] A zero rate means that, while no VAT is due on the supply, the supplier remains entitled to claim any input tax incurred in making that supply and is therefore entitled to a refund of that input tax if there is no output tax against which to offset the input tax.

The zero rate is sometimes known as exemption with credit.[139] Both terms are correct, depending on the approach taken to exemption and the structure of the tax. From one point of view, a tax rate of 0 percent is nonsense. It is not a rate of tax, and no tax is collected. A zero rate is therefore an exemption of the supply from output tax. A contrary argument is that in taxes with progressive rate schedules, a zero rate of tax is commonly found at the bottom bracket, so this is not a contradictory concept. It certainly works mathematically. The effect of a zero rate is approximately the same as that of a very low positive rate of tax. In any event, a zero rate does

[138] "Zero rate" has become the usual English-language term, except in EU documents. It is used, for example by Tait, *supra* note 2, ch. 3, and Hussey & Lubick, *supra* note 13, § 222; and in IRL VAT Second Schedule; NZL GST § 11; ZAF VAT § 11; GBR VAT § 30; KAZ TC arts. 62–66. (There is inconsistency in the use of the hyphen—both "zero rating" and "zero-rating" are found.) There is no direct French equivalent. The French CGI, art. 261, addresses "*opérations exonérées*," and this term is followed in the Swiss law. *See* CHE OTVA art. 15.

[139] Technically, in EU law, the requirement is that states exempt the supplies that are discussed here as zero rated. *See* EC Sixth VAT Directive, *supra* note 3, arts. 15–16. However, a separate provision grants a right of deduction for input tax. *Id.* art. 17. This has the same effect as zero rating. It is the form followed in most EU countries and elsewhere in Europe, for instance in Bulgaria. BGR VAT arts. 7–12.

make the supply "taxable" in a technical sense and therefore achieves the objective of bringing these transactions within the operation of the VAT credit for input tax, which an exemption does not. This is because a VAT credit is allowed only for inputs to be used in making taxable supplies. For this reason, those who do not accept the existence of the zero rate recognize the right to the credit for input tax by saying that these supplies are "exempt with credit." There are arguments in favor of both approaches, and the present writer will readily confess to regarding both as entirely proper ways of defining the process. The question is one of terminology, and the appropriate solution may depend on the language and practice of a particular state.

D. Zero Rating Exports and International Supplies

Why do states have a zero rate? Its main use is to deal with exports of goods and exported supplies of international services. The destination principle calls not only for removing a direct charge to VAT from exports and international services, but also for removing any VAT indirectly imposed on those supplies in the form of input tax paid by a supplier. Only if the input tax is rebated will the goods leave the state free of VAT. The arguments about zero rating exports are also sometimes applied to supplies to diplomats, which are typically zero rated. The justification is that embassies are to be regarded as outside the tax territory of the state.[140]

Another specific service that is often zero rated is the supply of international transport.[141] The zero rating is usually widely drawn to cover both the supply of the services themselves and also supporting supplies of goods and services (e.g., selling provisions to shipping or repairing an aircraft). This is often done to protect international transport businesses based in the state from uneven competition from other states.[142] For example, two companies, one based in state *A* and the other in state *B,* supply bus services between cities in state *A* and state *B*. If state *A* zero rates the transport supplies, and state *B* does not, there will be a strong inducement for passengers to travel with state *A*'s company. In addition, if tickets for the state *B* company are sold in state *A*, they may also be zero rated. An alternative approach of taxing the services in state *B*, but not beyond *B*'s frontier, might be theoretically attractive but will pose practical difficulties. Some states have adopted the alternative approach of imposing a separate excise tax on the tickets provided for international transportation.

Coordinating rules will be needed to deal with supplies that fall under both exemption and zero rating. For example, if medical supplies are generally exempt, what about an export of

---

[140] *See supra* sec. V(E) (discussing the exemption of diplomatic activities).

[141] This applies throughout the European Union and elsewhere in Europe. EC Sixth VAT Directive, *supra* note 3, art. 15. It is easier for island states, such as New Zealand, to avoid this problem because the competition is less severe.

[142] It also avoids problems for some states that have goods transiting across them between third states. The transport service is supplied in the state, but none of the parties involved need have any contact with it (save for the presence of the vehicle and cargo during transit).

medical supplies? Such an export should be treated the same as exports generally, for example, by excluding from the category of exempt transactions those that fall under zero rating.

E. Should Internal Supplies Be Zero Rated?

A few states zero rate some internal supplies. This is widely viewed as inappropriate, because it amounts to a subsidy of the activity or transaction treated in this way. It would usually be better to identify the policy reason for the subsidy and address it through a direct subsidy.[143]its activities is zero rated than is in fact the case. On the other hand, one aspect of zero rating is more consistent with the structure of the VAT: unlike exemptions, zero rating does not provide an incentive for suppliers to avoid input tax. *See supra* sec. V(G).

A few special cases exist where zero rating may be justified on internal supplies, notwithstanding the above point. One case is of monetary supplies made to the national bank of the state. Failure to protect the national bank from a charge to VAT on all supplies of gold to it may result in taxing the national reserves. Similarly, it is normally regarded as appropriate to protect supplies of the currency itself to the central bank from the imposition of VAT. This will have to be done in any event in some way, and the simplest way is through zero rating. Other financial supplies are of course likely to be exempt.

Another special case is that of the sale or other transfer of an ongoing business. The problem arises when a taxable person transfers a business activity to another taxable person. Strictly, the seller must treat the sale of the business as subject to VAT (usually at the main rate). The buyer must therefore pay, along with the purchase price, the VAT on that price. If the purchaser is also a taxable person in respect of that business, then the purchaser can claim back the whole of the VAT paid as a credit for input tax. However, the associated credit or refund may take some time to receive, depending on the rules in the state dealing with large rebates of input tax. There are therefore significant potential cash-flow problems for the purchaser even though, in the long run, the input tax can be recovered. For the tax authorities, the sale of an ongoing business presents no problem. The VAT is accounted for from the business before and after the sale in the same way. In the long run, therefore, the sale will involve no additional VAT or loss of VAT.

To avoid this short-term problem, and recognizing that in the long run there is no revenue significance in this kind of sale, some states provide that such sales or transfers are zero rated. This means that the transaction remains taxable and does not distort any claims for input tax by

[143] As discussed in sec. V(G) *supra*, there are similar problems with using exemptions. If it is determined to provide a VAT preference rather than a direct subsidy, the question arises whether the preference should take the form of exemption or of zero rating. The latter is more costly in terms of revenue. It can also be unwise as a political matter, because it would open the door for arguments to zero rate other internal supplies. Zero rating also leads to administrative problems, in that a supplier may claim that a greater portion of

the seller. Other states remove the transaction by taking it outside the scope of VAT, but in this case an adjustment may need to be made to deal with the problem of input tax.[144]

F. Paying VAT to the Tax Authorities

The law must establish a mechanism for each taxable person to account for the VAT collected by that person on sales, and to pay this tax over to the tax authorities at regular intervals, after deduction of any allowable input tax. The procedures for doing this are noted briefly in the next section. The element of substantive law involved is the right to claim a deduction for input tax.

[144] If a sale or other transfer of an ongoing business is taken outside the scope of VAT, then it must be provided that the business is treated as continuing regardless of the change of owner to prevent a break in the flow of output tax and claims for input tax and also to prevent any claims by the new owner for input tax already credited to the former owner.

G. Entitlement to Credit for Input Tax[145]

It follows from the definition of "value added" on which VAT is based that any VAT incurred by a taxable person as input tax should be repaid to that person in some way. The usual method of repayment is to allow the input tax to be set off as a deduction or credit[146] against output tax collected during the same period. A duty is imposed on the taxable person to pay only the net amount to the tax authorities. In principle, therefore, all relevant input tax incurred by a taxable person should be available for credit in this way.

While the mechanism for crediting input tax presents few difficulties for taxable persons who make only taxable supplies (or exempt supplies that carry a right of credit), two sets of problems arise in particular cases. The first is that of the person who makes both taxable supplies and other supplies (either exempt supplies or supplies outside the scope of VAT). The second is the need to safeguard the award of input tax credit against fraud and transactions that may cause revenue loss to the state by avoidance or evasion. In addition, many states have, partly to deal with the second problem, made provision in the law disallowing credit for some kinds of input tax. Further, credit of input tax on capital goods is sometimes limited and spread over a period of years. Both sets of problems are discussed below.

---

[145] Here again, there is inconsistent terminology in different VAT laws. The use of "output tax" (meaning the VAT imposed by the supplier on taxable supplies made by the supplier) and "input tax" (meaning VAT paid by the supplier) is now widespread in English-speaking countries, but it is by no means universal. The terms are used by Tait, *supra* note 2, but not in Hussey & Lubick, *supra* note 13, which uses the term "input credit." *Id.* § 231. "Input tax" is a defined term in the laws of New Zealand, NZL GST § 2(1); South Africa, ZAF VAT § 1(xxix); and the United Kingdom, GBR VAT § 24, but is not found in the EC Sixth VAT Directive, *supra* note 3, which focuses on tax for which the right of deduction has arisen. *Id.* arts. 17–18. The Swiss law refers to a right of deduction for the "previous tax" (*impôt préalable*). *See* CHE OTVA art. 29. The French law is not as consistent, referring to a deduction for the VAT "imposed on the elements of the price of a taxable operation", *see* FRA CGI art. 271, and in another place to a "deduction for the tax imposed on the goods or services which are not used exclusively for the realization of taxable operations." *See* FRA CGI art. 273. The lack of a precise term in the statute is perhaps due to the fact that the operative rules for input tax are left to regulations. *See id.* The term in the German law is *Vorsteuer*, which could be translated as advance tax. *See* DEU UStG § 15.

[146] Again, there is inconsistent use of terminology about whether the input tax is available for deduction or credit. We have noted that the EU laws refer to a right of deduction. EC Sixth VAT Directive, *supra* note 3, arts. 17–18. The alternative form is to refer to a "tax credit" or "VAT credit." The latter term is, in the view of this writer, slightly preferable because it emphasizes that the input tax may exceed the output tax (and, at the extreme, that there may be input tax when there is no output tax), so that the "deduction" exceeds the sum from which it is deducted. This gives rise to an excess deduction or, better, an excess credit. It also helps to emphasize that there should be a credit (or deduction) for all VAT incurred by the supplier for business purposes. Direct tax laws impose strict controls on deductions, and such thinking sometimes erroneously strays into VAT laws.

H. Partial Exemption

The main category of taxable person with problems in identifying the amounts of input tax available for credit is businesses that make some taxable supplies and some exempt supplies. These are often termed cases of partial exemption. The problem is the same for those that make supplies outside the scope of the tax. If a state has many exemptions from VAT, or has a limited base for the tax, these problems will be common. If a state exempts goods of a kind available for retail purchase, then a shop or business that sells these goods and other goods will be partially exempt. Most states exempt financial services; consequently, banks and other suppliers of financial services routinely confront the problems of partial exemption. For example, a finance house makes supplies of financial services, which are exempt, and also supplies business advice that is subject to VAT at the main rate. The finance house is a heavy user of telephones and incurs a substantial amount of VAT on its telephone bills. If the finance house were allowed to claim all the input tax on its telephone bills, it would be receiving excessive input tax. The law therefore allows the finance house to claim the VAT on the telephone bills that relate to its business advice services but not to its financial services. How is this to be handled?

The law must limit the right to claim a credit so that it covers only input tax incurred for the purposes of making taxable supplies. This requires a careful review of the total input tax paid by a partially exempt taxable person to separate out that input tax that is to be allowed and that which is not. There is no quick but entirely accurate way of doing this. The principles are that input tax incurred only for the purpose of making taxable supplies is allowed, but input tax incurred only for some other purpose or purposes should not be allowed. Input tax incurred partly for the purpose of making taxable supplies and partly for other purposes should be apportioned so that only the part of the supply devoted to making taxable supplies is available for credit.

There are significant practical problems in attempting to divide each item of input tax in this way, and a variety of solutions have been adopted in practice, such as averaging or estimating or generalizing from a partial audit of input tax. For example, the rules may be applied strictly for a trial period. During this period, the taxable person is required to identify any input tax paid on supplies acquired solely for the purpose of making taxable supplies, any input tax paid in connection with making supplies that are exempt, and the input tax to be apportioned. The input tax is apportioned in proportion to the total of taxable supplies and the total of exempt supplies (and, depending on how the law is structured, supplies outside the scope of the tax). This produces an overall ratio of taxable supplies to total supplies that might be, say, 40 percent. In the following year, unless either the tax administration or the taxpayer dissents, the same ratio of 40 percent can be used for allowing input tax without asking the taxable person to keep the same detailed records.

I. Disallowed Input Tax

It is increasingly common practice for states to deny input tax credits for certain kinds of supply. The main group may be described as supplies of or for luxuries, amusement, or entertainment. The precise application of a rule such as this will involve careful definitions. For example, supplies of "luxuries" to a luxury business cannot be disallowed fairly if the business is thereby prevented from recovering input tax on goods it buys in order to sell. By contrast, expenditure on business entertainment, such as a lavish meal for members of the staff of the taxable person, may more readily be disallowed. The justification is that these forms of input are always personal consumption. In effect, there is considered to be a deemed supply to the person benefiting from the expenditure. Denial of the input credit is an administratively simple mechanism for dealing with this deemed supply. There will also always be marginal cases, such as the claim that a racehorse or a yacht bearing the name of the taxable person's products is not a luxury or that a particularly expensive item is bought for the business and not for the benefit of those who own the business.

In some states, all credit for input tax on cars is disallowed, sometimes with exceptions, such as for taxis and rental cars.[147] Input tax on vans or trucks is allowed. Many states already have rules for income tax and other purposes distinguishing between cars and vans, and they can also be used for this purpose.

J. Capital Goods

For revenue protection reasons, some states have rules that require input tax on capital goods, or certain kinds of capital goods,[148] to be set off over a period of years in much the same way as the deduction of capital expenditure is controlled by capital allowances or depreciation for income tax purposes.[149] These rules are exceptions to the principle that, in general, no distinction is made for VAT purposes between revenue transactions and supplies and capital transactions and supplies. As such, rules identifying capital goods and applying limitations on credit of input tax are a breach of the fundamental principles underlying VAT because they

[147] The EC Sixth VAT Directive, *supra* note 3, art. 17(6), provides that "VAT shall in no circumstances be deductible on expenditure which is not strictly business expenditure, such as that on luxuries, amusements or entertainments" and provides a procedure for agreeing on these disallowances. However, member states have failed to agree on a common set of rules for such deductions, and the article allows existing national disallowances to continue in force. The disallowance on cars applies in Denmark, France, Portugal, and the United Kingdom, and with exceptions in Greece, Ireland, Italy, and Spain. *See* Tolley's VAT in Europe, ch. 7 (1995). If a credit is denied for cars, it will generally be appropriate to exclude from the denial cars that are used for rental or that are held for resale.

[148] This approach was carried into the VAT in Russia and some other states of the former Soviet Union from the previous turnover tax under which expenditure on equipment did not qualify as a deduction against the sales tax payable. The EC Sixth VAT Directive, *supra* note 3, provides for adjustments for input tax credits to spread the credits on equipment over five years and on immovable property over ten years, although member states have the right to disapply the rules. *Id.* arts. 19–20.

[149] If such rules are adopted, the law must address the same issues, including the distinction between capital and revenue items, as under the income tax. *See* vol. 2, ch. 17.

prevent—or, rather, delay—the credit of all relevant input tax. As delay imposes cost, these rules create a distortion.

K. Safeguarding the Revenue

Claims for input tax credits are an inherent part of VAT, which is a tax on differences. Any attempt to curb input tax credit is therefore wrong in principle because it changes the way VAT operates from a tax on value added to a tax on gross sales prices. States are entitled to protect the revenue base of the VAT against abuse of the credit procedure in order to ensure that improper claims for input tax are not made. A major threat to the integrity of the revenue base exists where input tax exceeds output tax and a claim is made for a refund to the taxable person of the amount of the excess. In a perfect VAT system, all such claims should be allowed within the normal time scale for paying the tax. However, some states have encountered widespread fraud in the operation of this practice, making safeguards necessary. Some can be linked specifically with the payment of a refund. The state should ensure that the rules dealing with input tax credits are clear and effective so as to prevent any doubt as to the extent of entitlement. This should also make it easier to check claims and audit taxable persons making claims.

L. Bad Debts

The rules suggested in this chapter are designed to ensure timely payment of the VAT related to a supply. Under these rules, occasions would frequently arise when the VAT has been paid on a supply to the tax authorities, but payment for the supply is not received until a later time. In the extreme cases, more common in economies in transition, some or all of the payment will not be received at all, because the customer becomes insolvent or in some other way the debt becomes bad.

Payment of VAT to the tax authorities ahead of receipt of the VAT from the customer is a normal aspect of a VAT. This may provide a cash-flow disadvantage to the taxable person. In many states, this disadvantage is not particularly significant because the taxable person benefits from a much greater cash-flow advantage that arises from holding VAT collected from some customers for several weeks before having to pay it to the tax authorities. In addition, the supplier may recover some of the economic cost of the delay in payment through an interest charge on the sums outstanding. Where this happens, the interest charge is not subject to VAT. In addition, where the customer is a taxable person and receives an input credit for the VAT on the transaction, the customer could use the cash saved by the input credit to pay the supplier at least the amount of VAT. The parties are always free to make such an arrangement as part of the terms of their sales agreement. If they do not make such an arrangement, then the seller is in effect extending a credit to the purchaser above and beyond the cost of the goods.

Bad debts may be seen as presenting a different problem. It is no longer one of cash flow, but of ensuring that the tax remains a tax on value added. If payment is not received by a supplier, then the supply may result in a loss to the supplier, with no value added. A distinction may be drawn between the case of the very slow payer and the person who cannot pay. A solution to the problem of nonpayments, as opposed to late payments, may entail a specific allowance for bad debts.[150] This allowance will amount, in effect, to the equivalent of input tax to offset any output tax paid to the tax authorities but not collected from the customer.

If this approach is followed, a definition of "bad debt" is needed to ensure that any allowance for a bad debt does not encourage slow payment. For this reason, it is important that the mere fact of nonpayment should not make the debt bad. It should be shown that the debt is not collectable with reasonable effort on the part of the supplier, and that a minimum set time has elapsed. The length of that period will depend in part on the business practice of a state and on its economy. Inflationary factors are clearly relevant, as is the usual practice for payment of bills. Where all bills are long delayed before being settled, the period for this provision will need to be longer.

While it is typical to provide an allowance for bad debts, there is a counterargument. On the assumption that finance charges are set at a level adequate to compensate for bad debts, the total group of borrowers bears the burden of bad debts through the interest payments they make. The cost of the consumption by defaulting customers is therefore borne by other borrowers. But because interest is not subject to VAT, there would be an understatement of the overall tax base if the amount of bad debts were subtracted from the base, in addition to excluding interest. The difficulty in deciding on an appropriate policy for bad debts is that not all bad debts are covered by finance charges. Instead, suppliers may take the risk of bad debts into account in setting prices for all. On this assumption, it would be appropriate to provide an allowance for bad debts. In the case of bad debts owed by customers who are themselves taxable persons, however, a bad debt allowance would not be necessary. If an allowance for bad debts is made, there should also be a reversal of the customer's input credit, leading to a wash. The conclusion is that the case for a bad debt allowance is not as obvious under the VAT as it is under the income tax, and that under certain assumptions such an allowance would not be needed.

VIII. Procedure and Administration

A. Need for Specific VAT Rules

Legislative approaches to dealing with administrative and procedural provisions of tax laws vary markedly from state to state. It is therefore difficult to provide any general form of provision for the procedure that must be associated with the collection of VAT by taxable persons or for the administration of VAT by the tax authorities.

In general, there are distinct advantages to combining, as far as possible, the procedure and administration of VAT with that of other taxes. If this is done, then the matter can be dealt with in common laws dealing with taxes generally and with compatible procedures. This is more efficient for the administration and easier for taxpayers to understand.

[150] *E.g.,* GBR VAT § 36.

B. Combining VAT and Customs Administration on Imports

The case for combining the collection of VAT on imports of goods with the collection of customs duties is particularly strong. Questions of procedure for handling VAT on imports should as far as possible follow the procedures followed for customs duty purposes, just as this chapter has assumed that the substantive law follows customs duty law. Similarly, there is a clear case for giving the duty of collecting VAT on imports to customs officials. For that reason, the relevant administrative provisions should be aligned to customs laws. The simplest form of provision is one that treats VAT on the import of goods as a customs duty for all purposes of administration of VAT. This would mean that customs officials can use the same powers to enforce VAT on imports as they have to deal with customs duty. This approach will ensure that powerful provisions exist to handle VAT on imports with a minimum of legal difficulty, administrative provision, and taxpayer confusion.

C. Handling VAT on Internal Supplies

There is also a strong argument for combining the administration of VAT on internal supplies with the administration of the direct taxes. In particular, many income tax payers with business income will also be taxable persons for VAT purposes. Many transactions will require review for both income tax and VAT purposes, although the ways in which income tax and VAT liabilities are calculated from that common base are radically different.

Despite the differences in result, many of the problems of administration of direct taxes and VAT invite similar solutions. For example, the powers of auditors carrying out field audits, or those of desk officers demanding information from taxpayers or from third parties may be aligned. There is an additional advantage in aligning these powers in that officers will be able to gather information for the two kinds of tax liability at the same time, thereby minimizing the demands on taxpayers. This approach also enables a cross-check on compliance with the requirements of one tax from information gathered in checking compliance with the other. One of the strengths of the invoice-based form of VAT is the resulting audit trail, which can be used to check other taxes.

In the light of these general remarks, this chapter discusses only those areas of administration and procedure that are peculiar to VAT. It is assumed that for other matters the state will have separate legislation dealing with tax administration or that the rules in the VAT law will parallel those in other tax laws.

D. Regulations, Instructions, and Guidance

The VAT is an invasive tax and potentially applies to every aspect of the economy. It is impossible to set out in one law all the rules, regulations, procedures, and working practices necessary to ensure the smooth operation of a tax that can apply to several millions of transactions a day in a state. Not only does the VAT have this invasive, and pervasive, effect, but it must also take a clear enough form so that all those charged with settling transactions and issuing VAT invoices can do so with confidence and without delay. The laws, rules, and guidance must be effective, and the legislation is no more than the highest level of a multilayered system of providing rules and procedures.[151]

E. VAT Invoices

A VAT invoice is an invoice, chit, till roll print, or other document[152] that is issued by a taxable person who makes a taxable supply and that records the supply and the amount of VAT payable on it. In an invoice-based VAT system, as described in this chapter, the issue of invoices in the proper form is an essential part of the procedure for imposing and enforcing the VAT. The requirement that a special invoice be issued is a feature unique to VAT.

An invoice is a "VAT invoice" if it complies with the requirement of the VAT law. Invoices issued for other purposes or that do not comply with these requirements do not count as VAT invoices.

VAT laws typically condition the allowance of a credit for input tax on the existence of a VAT invoice issued during the period for which the credit is claimed. An invoice is also required by the tax authorities to audit the collection of VAT. To allow these requirements to be met, the law should require a supplier making a taxable supply to another taxable person to provide a VAT invoice with that supply or the payment for it. The requirement should be enforceable by some penalty or procedure. The law could further specify that the purchaser's copy of the invoice, once created, is the property of the tax authorities, and not of the supplier or the purchaser.[153]

The timing rules noted previously[154] are linked to the time of issue of a VAT invoice. For that reason, together with the reasons noted in this paragraph, the supplier is usually required to issue the VAT invoice at the same time as, or soon after, the supply. For example, the law might require the supplier to issue a VAT invoice no more than seven days after the delivery of goods or payment for those goods. This type of short time delay ensures that an invoice in respect of a transaction, say, at the end of the last working day of a week can be legally issued at the beginning of the following week.

---

151 *See supra* ch. 2, sec. IV; ch. 3, sec. IV(D).

152 There is a strong case for providing in regulations for paper records to be substituted by electronic records in some cases, provided that the requirements of evidence for effective auditing are also met.

153 This would impose a duty on the person holding the invoice to preserve it and produce it on demand.

154 *See supra* sec. III(H).

A VAT invoice is normally required to be identified as such (perhaps by having the words "VAT invoice" on it) and to contain a minimum of information about the supply being invoiced. That information would normally include[155]

- the name, address, and VAT number of the taxable person making the supply,
- the nature of the supply made (type of supply, type of goods or services, and quantity of goods or extent of services),
- the time the supply was made,
- the amount of payment for the supply,
- the amount of VAT,
- the name, address, and VAT number of the taxable person supplied,
- the date on which the invoice is issued, and
- the serial number of the invoice (together with identification of the printer if the invoice was purchased privately).

A state may not need to include all this information. For example, if there is only one rate of VAT, then it is redundant to state both the amount of VAT and the amount of payment for the supply. The redundancy may, however, be considered appropriate in light of the fact that taxpayers can make computational mistakes, particularly if both exempt and taxable sales are shown on the same invoice.

The requirement to include all this information will make a VAT invoice a formal document. This will not be appropriate for small transactions, for example, those made by a retail store, particularly where the customer is not a taxable person. States frequently allow special simplified invoices for small transactions or for transactions recorded in a retail store in a till or cash register. For example, in these cases, it will not be required that the details of the customer be recorded unless, perhaps, the customer wishes it. For the sake of clarity, the law should distinguish between the formal VAT invoice[156] and simplified invoices. Only the VAT invoice will entitle the purchaser to a credit for the VAT shown on the invoice, and special procedures will apply to the VAT invoice that do not apply to simplified invoices. While the basic distinction should be drawn in the law, matters such as acceptable forms for simplified invoices are best dealt with by regulation and guidance.

It will make for efficient administration if the tax authorities produce examples of the forms of VAT invoices acceptable to them that comply with the law. However, it is better that this level of detail be omitted from the main legislation. Flexibility should be provided, for example, to allow computer-issued invoices.

F. VAT Returns

---

[155] *See, e.g.,* The Value Added Tax (General) Regulations 1985, art. 13, *reprinted in* Butterworths VAT Handbook 1995, at 465.

[156] This is typically known as a "tax invoice."

The other essential document in administering a VAT is the required provision of information at regular intervals by all taxable persons. This provision of information and the document on which the information is provided is commonly known in English as a "return." There should be a standard form of return, so that taxable persons know precisely what is required of them and can comply more easily with the formalities of making a return, and so that the tax administration can process returns efficiently.

All taxable persons should be required to make a return of their taxable transactions and other relevant information at predetermined and regular intervals. These intervals are called "VAT periods."[157]

The return should cover all taxable transactions made by the taxable person during the VAT period and should show how much VAT is payable to the tax authorities for that period.

The essential information on a return is therefore the following:

- the total VAT collected on all taxable supplies made by the taxable person (output tax) in the VAT period,

- the total VAT paid by the taxable person on supplies made to the taxable person in the VAT period and for which a credit is allowed (the allowable VAT credit or input tax deduction),

- the amount of any bad debts to be set off against output tax in that VAT period, and

- the amount of any excess of allowable input tax over output tax in the previous VAT period that can be carried forward (allowable excess VAT credit or input tax deduction).

The requirement that a return be made for each VAT period needs to be enforceable, with a reasonably strict time limit for submission, such as within 15 days of the last day of the VAT period to which the return relates. A return should be required even if the taxable person has no taxable supplies for a VAT period. This rule allows efficient operation of systems to detect and chase after persons who are delinquent in filing.

G. Payment of VAT

The law should also specify that all taxable persons must pay to the tax authorities at a specified time the net amount of VAT due for the VAT period (i.e., all VAT collected (output tax) less allowable VAT credit (deduction for input tax) and any allowable excess VAT credit carryover and VAT with respect to bad debts).

[157] *See infra* sec. VIII(J).

The duty to pay is usually on a self-assessment basis (i.e., the taxpayer itself determines the amount due by filling out the return). Each taxable person is responsible for paying the VAT due to the tax authorities in respect of any VAT period at the same time as (or, if convenient, separately but before) the return for that period is due.

Some states require advance payments of VAT, for example, three times a month, based on VAT liability for previous periods.[158] The advance payments are then credited against the VAT due with the return.

H. Assessing VAT

Where a return has not been made by a taxable person (including persons not registered for VAT that should be registered or importers not covered by the import procedures) for a period for which a return should have been made, the tax authorities should be given reserve powers to impose an obligation on the taxable person to pay VAT to the tax authorities. For example, the tax authorities can be empowered to make a formal assessment[159] of the estimated amount of VAT that a taxable person or other person is believed to owe to the tax authorities in accordance with the law.

The tax authorities should also have the power to collect any other VAT, estimated amounts of VAT, or sums equivalent to VAT. This can deal, for example, with an unauthorized person issuing what purports to be a VAT invoice. The "VAT" collected by that person is due to the tax authorities, and the power to assess could provide the most convenient way of doing this.

The power to assess should also be available to deal with cases where the tax authorities have reason to believe that the returns made by a taxable person are not accurate and do not show the full amount of VAT due from that person. The tax administration law should deal with the formalities of making assessments and procedures for challenging them.

I. VAT Periods

The payment of VAT to the tax authorities is linked to a "VAT period" as explained previously. The length of a VAT period is a policy matter for the state. The standard period is the calendar month; often, taxable persons with small levels of taxable turnover are allowed to use longer periods of three months or a year.[160] The VAT period should be distinguished from payment periods.[161] Thus, for example, a state may require enterprises of a certain size to make

[158] *E.g.*, KAZ TC art. 72(1).

[159] The process is an inherent part of the income tax in most states, and it will be efficient to apply the same procedures used for the income tax, except for those that are not relevant to VAT.

[160] In economies with high levels of inflation, shorter periods may be appropriate. *See infra* ch. 13, sec. II.

[161] *See supra* sec. VIII(H).

advance payments of VAT three times a month, while the VAT period remains a calendar month.

J. Repayment of Excess VAT Credit

Where the input tax credit for any VAT period exceeds the output tax collected, there is an excess of VAT credit or of deductible input tax. As a direct result, the taxable person will pay no VAT to the tax authorities for that period. However, should the tax authorities pay the difference to the taxable person?

VAT is fundamentally different from direct taxes in that it involves regular situations where a taxable person is owed money from the tax authorities. This is an essential feature of VAT if it is truly a proportional tax based on regular VAT periods. The situation will arise, for example, where the taxable person buys expensive equipment or machinery costing more than the total of taxable supplies made by the taxable person during that VAT period. It also arises if the law makes provision for rebating tax to exporters.

Policymakers may be tempted to reduce or abolish the right for taxable persons to demand payments from the tax authorities, especially where state budgets are under pressure. There is an opposite temptation on political representatives to make the operation of VAT "fair" by imposing the same tight timetables on the tax authorities rebating VAT as on taxable persons paying it.

Both temptations can present major problems for the state and the tax authorities if the rules concerning VAT refunds are not carefully formulated and applied. A failure to allow any repayment of excess input tax undermines the fairness and economic neutrality of VAT collection. If applied to exporters and other similar taxable persons, it can harm the economic competitiveness of those persons and therefore of the state.

By contrast, a regime demanding early rebates of excess VAT credit or excess deductible input tax places a tax authority at a disadvantage in dealing with evasion and fraud. In particular, there is a danger that rebates will be given in situations where an input tax credit has been claimed for a supply but the supplier (or alleged supplier) of the supply (or alleged supply) has not paid an output tax to the tax authorities. There is also a danger of persons representing themselves as taxable persons when they are not, in order to claim input tax repayments when they have no intention of paying more than a nominal amount of output tax to the tax authorities. In the worst case, the so-called taxable person will simply disappear after receiving the credit, having made money from the tax authorities. There will also be cases where an expenditure that is not made for business purposes is said to be made for business purposes (e.g., on the purchase of a car or boat), so that an input tax repayment is made for input tax not paid out for business purposes.

Balancing these two pressures on a tax authority has proved problematic in a number of states. Repayments of excess VAT credit should be allowed, but with safeguards. One possible safeguard is to require the excess VAT credit to be carried forward for a specified period (e.g., six months) before a repayment can be claimed. Another safeguard for the revenue is a phasing of VAT credit on large expenditures through capital goods rules.

Further safeguards should empower the tax authorities to audit any claim for repayment before being required to make the repayment if there is reason for suspicion. For example, if the tax authorities are bound to make the repayment within a certain time, they should have the right to stop the time running if an audit is carried out. It is also important that the tax authorities have all the powers necessary to carry out these audits, and that they be seen to exercise those powers. The tax authorities should also have the power to assess taxable persons (or others) to recover excess repayments of excess input tax.

Another safeguard is to allow the tax authorities to require securities or guarantees (e.g., from a bank) to ensure that the taxable person continues making taxable supplies after the repayment is made or to make repayments only when subject to other conditions for the protection of the integrity of the revenue. Where the financial system allows, this may be a particularly convenient way of balancing the needs of the tax authority with the entitlements of larger taxpayers.

IX. Special Cases

The potential complexity of VAT when applied to every form of taxable supply has been mentioned. There will, in practice, be whole classes of supplies and of taxable persons where one or more of the general rules of VAT pose difficulties or uncertainties. Small businesses may find that some aspects of VAT procedure impose heavy burdens. Specific sectors of economic activity such as farmers may have difficulty conforming with the way the tax works. Auctioneers or other agents may have difficulty determining how VAT applies to their supplies. Problems may arise for them and for other kinds of agent in the supply of items between taxable persons and nontaxable persons. Taxable persons such as retailers may find it difficult to account to the tax authorities for the VAT on a large number of low-value supplies, particularly where only some of the customers are other taxable persons.

A detailed study of any fully developed VAT law will reveal a range of special rules derogating from the general framework in particular cases. These derogations are usually designed to make VAT workable. The law should make provision for these special rules to be created. This is probably best done in most states through regulation although, in some areas, it may most effectively be done through agreement with trade organizations or after discussion with other government agencies. While these schemes should be the exception rather than the rule, some special provision is usually unavoidable.[162]

---

[162] The EC Sixth VAT Directive, *supra* note 3, makes provision for a number of special schemes, including for small undertakings, *id.* art 24.; a common flat-rate scheme for farmers, *id.* art. 25; for travel agents, *id.* art. 26; and for secondhand goods and works of art, *id.* art. 26a. The member states of the EU do not have common schemes for these special cases (except for secondhand goods, where a common approach was agreed upon in 1994, Directive

94/5 of February 14, 1994, 1994 O.J. (L 60) 16, nor have they all adopted the special schemes. Other special schemes are allowed by derogations, for example, fisheries (Belgium and Netherlands), oil and gas (France), and gold (United Kingdom). *See* the summary of national laws *in* Tolley's VAT in Europe, *supra* note 162. However, the approach of countries with a broad-based tax, such as New Zealand, is to avoid these schemes wherever possible.