An introduction to VAT

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The world seems to have capitulated to the rise of indirect taxes and king of them all is Value Added Tax (VAT). Since the early 1990s VAT has been adopted by various countries as an efficient alternative revenue source. But there are those who are still holding out, the GCC is one of them, along with a number of Middle Eastern economies. The US also remains a stronghold of sales tax rather than VAT. However, there are constant suggestions that VAT may be introduced in both the US and the Middle East. But with President Obama denying any VAT agenda, it is probably safer to assume that countries in the Middle East will adopt it first.

How long these countries will hold out on introducing VAT is unclear, but one thing is certain, VAT is now firmly part of the tax landscape, and a very effective one too.

A very effective source of revenue

VAT is a tax on services and goods and so is very similar to the so-called sales taxes though it usually applies with a very wide base. However, it has one unique aspect, which is that each party in the chain may deduct the VAT charged by a supplier ('input VAT') from the VAT due on sales ('output VAT'), paying the difference to the authorities – hence the term 'value added' tax. In essence it seeks to tax each part of the supply chain and avoids a cascade of tax charged on tax.

The business community acts as a tax collection agent, so there is little cost to the tax agency in collecting the money from the ultimate payers (generally the public), albeit there is a hidden cost for businesses in ensuring compliance.

There are multiple points at which to collect tax along the supply chain; this means tax is collected earlier, the risk of fraud is diffused and there are incentives to be honest: get a receipt and you can claim the VAT back and, once a receipt exists, it can be verified and checked, making VAT highly effective at raising money for the government.

Exactly!

In fact one of the principle reasons for the US failing to introduce a VAT system is that it would be a 'money machine' and encourage 'big government'[i]. This reasoning does not seem to have concerned most other Governments. In fact, the cheapness and ease of collection makes VAT particularly attractive and the tax is increasingly spreading to traditional tax free environments where old sources of revenue are becoming less reliable. Table A below provides an illustration of the aggregate administrative cost of VAT collection in various countries.

Table A: Comparison of aggregate administrative costs to net revenue collections[ii]

Country	Administrative costs/ net revenue collections (costs per 100 units of revenue)				
	2000	**2001**	**2002**	**2003**	**2004**
Australia*	-	1.06	1.07	1.05	1.05
Canada	1.07	1.08	1.2	1.33	1.17
France	1.4	1.41	1.44	1.41	1.35
Japan	1.42	1.54	1.66	1.67	1.58
Netherlands	1.7	1.74	1.76	1.39	1.3
Singapore	0.87	0.9	0.99	1.01	1.02
Slovak Republic	1.3	1.43	1.46	1.45	1.26
Spain	-	0.81	0.78	0.83	0.82
Sweden	0.52	0.55	0.56	0.57	0.59
UK	1.02	1.06	1.11	1.04	0.97

Source: * Australia: data as per revenue body's annual report for 2006

(i) President's Advisory Panel on Federal Tax Reform (2006, p. 192).

(ii) Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series (2006): 2007

So what's to stop this economic nirvana?

Clearly there is a big cost for business in collecting VAT and the number one burning issue of in-house indirect tax managers is the daily struggle to cope with competing priorities and manage systems and processes[iii]. The OECD estimates that the administrative burden resulting from tax regulations represents between 25-30% of a business' overall administrative cost. In monetary terms this is significant, with EU businesses estimated to spend well in excess of €60bn per year on complying with VAT regulations alone.

VAT also has an impact on retail prices. In practice it seems the inflationary impact of VAT is generally limited to its introduction or changes in rate and rarely results in a built-in inflationary pressure that persists. But there is an impact: this can be seen when rates rise and fall, a frequent occurrence in Europe this year. (see Table B below).

However, the biggest issue cited about VAT is that it is regressive, so it impacts the poor more harshly than the rich as a proportion of income. For this reason we have a proliferation of 'special rules' around food, health and education (to name a few), all with their own special social positioning to suit local circumstance. In South Africa for example, tinned vegetables are taxed as a luxury, in the UK one pays VAT on crisps (chips to some), but not on the humble potato and so on. These rules add complexity, room for dispute, and generally damage the purist nature of VAT, but they serve important social requirements. Whilst in theory there are better ways of redistributing the income, often there is no infrastructure to do this and VAT exemption is a convenient (and media popular) shortcut.

VAT also has issues of outright fraud. Any system that involves repayments of tax to taxpayers will attract the unscrupulous: the person who claims to be exporting goods, selling fruit or commencing trade with no income. All of these could be in a repayment position or could be false, and thus need policing.

Selected design aspects

There are other special rules that are adopted to suit local circumstance. In the EU for example, many countries operate 'blocks' of VAT recovery on goods they consider might be used for private purposes (cars for example), special reduced rates for specific industries (labour intensive, construction, hotels) each driven by local politics, cultural preferences, economics and lobbying.

Then there are the exemptions of necessity. How does one subject a margin on a forex transaction to VAT, especially when it might turn negative the next day? The simple answer is that one does not. So as a result many systems have an exemption for financial services.

What does exemption mean? Well different countries use different words, but it can mean, in effect, a nil rate

Table B: VAT rate changes in Europe, 2010

Country	VAT rate change	New VAT rate	Effective date
Finland	+1%	23%	1/7/2010
Greece	+2%	21%	15/3/2010
Czech Republic	+1%	20%	1/1/2010
Spain	+2%	18%	1/7/2010
Portugal	+1%	21%	1/7/2010
Greece	+2%	23%	1/7/2010
UK	+2.5%	20%	4/1/2011

Source: Deloitte

(iii) The Burning Issues 2009 Third Edition: Deloitte Global Indirect Tax of VAT, because businesses recover VAT on their costs. This is often called zero-rate or exemption with credit and is usually applicable to food, for example.

Then there is 'proper' exemption, where the business does not get to recover its VAT on costs. The Australians - rather honestly - call this 'input taxed'. This tends to be the form of exemption around financial services, for example.

VAT as a business issue

So, if you are heading into a VAT environment either by choice because you are entering a new market or because it is being introduced, then you need to think about its impact because it permeates every aspect of your business.

Every invoice that arrives needs recording, the VAT element separated and booked. It needs coding as recoverable (fully or partly) or irrecoverable. The invoice needs checking to ensure it contains the correct legal details. VAT on substantial capital costs may not be eligible for immediate recovery and at the very least will be subject to audit due to the potential for fraud.

Each sale and income stream needs accounting for correctly. Is VAT due? If not, is it because it is exempt or is it zero-rated? Is it subject to a reduced VAT rate? Could you argue for a better treatment?

Returns must be prepared, payments made, cash flow considered (VAT is often due on an accruals basis leaving the taxpayer holding bad debt risk) and audits dealt with.

Many VAT issues can be dealt with via good systems, clever handling of data can ease the preparation of returns meaning that tax and finance functions can spend their time more fruitfully analysing strategies, saving money and negotiating with the tax authorities from a position of strength.

So the flow of data for VAT is perhaps its most important aspect. How does the VAT feed into your ERP system, do you have sufficient tax tables for your ERP system to handle and allocate tax and prepare accurate VAT return forms? And since VAT across jurisdictions has many commonalities it is possible to have cross jurisdiction compliance processes and early investment will always reap dividends for the prepared.

If you get the systems right, you'll be 70% of the way there...the remaining 30% is where the real work lies.....

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