Design issues in a credit method value-added tax for the United States

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Design Issues in a Credit Method Value-Added Tax for the United States

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Foreword

Interest in a value-added tax (VAT) does not seem inclined to go away. A $3 trillion national debt, annual federal deficits that—even in an era of trust fund surpluses and Gramm-Rudman-Hollings spending restrictions—seem difficult to bring down to below $100 billion, and the fact that the major effort in 1984–86 to reform the income tax system produced a result that was essentially breakeven have encouraged a continuing perception that some other major revenue source may yet have to be found if the United States is to be truly serious on the subject of fiscal responsibility.

Whatever its drawbacks, few will dispute that a VAT can produce substantial revenues. In its most recent report on annual budgetary options, issued in February 1989, the nonpartisan Congressional Budget Office (CBO) estimated that a 5 percent VAT on a comprehensive consumption base would raise over $490 billion in the five fiscal years ended September 30, 1994. Even a VAT designed to avoid certain regressive features by putting a zero tax rate on food, housing, and health care would raise over $280 billion in the same period. In contrast, the same CBO report projects that changing the present income tax system to add a 33 percent permanent bracket would raise “only” $43 billion for those five years and, alternatively, raising the 15 percent and 28 percent marginal brackets in today’s system to 16 percent and 30 percent, respectively, would produce $167 billion for the five years. In short, VAT arithmetic is extremely powerful.

Historically, the American Institute of Certified Public Accountants (AICPA) Tax Division has had a substantial interest in the VAT. The Tax Division’s Statement of Tax Policy No. 2, issued in 1975, is titled Value-Added Tax. In addition, the AICPA published a study document in 1985 titled Alternatives to the Present Tax System for Increasing Saving and Investment, which considered, inter alia, both transactional consumption taxes (such as VAT) and a progressive annual consumption tax.

Statement of Tax Policy No. 2 concluded that the imposition of an indirect tax at the federal level “merits serious consideration.” It concluded further that should such a tax be adopted, the preferred form would be a national retail sales tax. Finally, it concluded that were a VAT rather than a retail sales tax adopted, it should be of the “classical” type (that is, with liability determined under the credit method) and should involve expensing of capital purchases.

We are now approaching fifteen years from the issuance of that policy statement, and although fiscal conditions have changed, interest in a VAT is still with us. Accordingly, the AICPA Tax Division continues its strong interest in this subject. A task force is organizing to restudy the policy issues inherent in broad-based consumption taxes, with the expectation that an updated or revised policy statement will be issued in 1990 or 1991.

This paper is not a policy statement but, rather, a study document. It takes no position on whether the United States should adopt a VAT (or any other form of tax on consumption). Instead, it focuses on the question, If the United States were to adopt a value-added tax, what issues need to be considered in designing that tax to make it both fair and flexible? We therefore believe this study can contribute significantly to an understanding of the problems that would inevitably be encountered in designing such a tax.

This study document was prepared by Lorence L. Bravenec, Director of the Graduate Tax Program and Thomas W. Leland Memorial Professor at Texas A&M University. Professor Bravenec served on the AICPA Tax Division Task Force on the Value-Added Tax from 1980 to 1984.
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J. M. Busby—VAT Tribunals, London
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Paul Chisnall—British Bankers Association, London
Nigel Cockburn—Price Waterhouse, London
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David Williams—Centre for Commercial Law Studies, Queen Mary College, London
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INTRODUCTION

The value-added tax (VAT) will undoubtedly be considered seriously whenever the federal government realistically tackles its budget deficit. The alternatives to a VAT are to broaden the federal income tax base further, increase federal income tax rates, or both. None of these alternatives to a VAT may be attractive to a Congress that has recently struggled mightily to broaden this base and reduce these rates.

It is generally assumed that if a VAT is adopted in the United States, it will be a credit form, along the European model. This study considers selected design issues in a credit method VAT for the United States, based largely on the United Kingdom's experience with its VAT. The study neither duplicates nor evaluates the federal government's major VAT design work: Value-Added Tax, volume 3 of The Treasury Department Report to the President—Tax Reform for Fairness, Simplicity, and Economic Growth. Instead, the study complements and extends the Treasury report.

The study is organized as follows: Chapter 1 considers extensively the flexibility of a VAT and the manner in which a VAT could be used to influence taxpayer and citizen behavior. Chapter 2 briefly lists possible design criteria. Chapter 3 considers how a VAT might be designed to operate cost-efficiently from the points of view of government administration and taxpayer compliance. Chapter 4 evaluates various special provisions from the points of view of efficiency and avoidance prevention effectiveness, on the assumption that special provisions will or should intrude on a VAT of the United States just as they intrude on its income tax. Finally, chapter 5 considers the design of a VAT that will be fair in both reality and appearance, including approaches for building progressivity into the VAT.

The reader should recognize some of the shortcomings of this study. It is based largely on the author's observations of the U.K. VAT and on his conversations and interviews with U.K. persons with VAT expertise. Nevertheless, because the U.K. VAT is based on comprehensive guidelines set out by European Economic Community directives, the study is generally representative of the experiences of the other European Economic Community nations.

Further, although the study is generally comprehensive, it does not attempt to duplicate the discussion found in the 1984 Treasury study and it does not deal with special problems presented by the federal system of government in the United States. Thus, the study does not cover design issues arising out of an attempt to integrate a federal credit method VAT with state sales taxes or state credit method VATs.

It is hoped that the study will give insights and information about the credit method VAT that are not presently available and that it will encourage and assist further work by interested persons.

Although members of the AICPA Tax Division's Federal Taxation Executive Committee, Tax Policy and Planning Subcommittee, and staff, together with VAT-knowledgeable U.K. persons, have commented on matters found in this study, the author is solely responsible for all matters contained in the study. The author expresses his gratitude to the foregoing persons, as well as to the organizations contributing to this study and to the U.K. practitioners interviewed, for their substantial assistance in this study.
Chapter 1

FLEXIBILITY AND NEUTRALITY OF THE VAT

Care should be taken that a value-added tax (VAT) is not oversold as a neutral tax. Proponents of a credit method VAT for the United States often cite the supposed neutrality of the VAT—its minimal impact on the operating, financing, and organizing decisions of business enterprises—as a primary advantage, in contrast to the nonneutral income tax. The income tax, however, is not inherently nonneutral. It is simply highly flexible and therefore capable of being made nonneutral by Congress. The lack of neutrality of the U.S. income tax derives largely from its tax rates, its failure to integrate the corporate and individual income taxes, and its timing of income realization and deductions.

Accordingly, if a VAT for the United States is to be comprehensive, but neutral in the sense that it does not affect business decisions, it must either escape the influence of the political processes that converted the U.S. income tax into a nonneutral tax or lack the kind of flexibility that permits nonneutrality. Neither neutrality assumption for the VAT appears well-founded. To assume that a VAT would escape political pressures and other considerations similar to those affecting the U.S. income tax is unrealistic. Further, as discussed subsequently, the VAT is an extremely flexible tax. For similar reasons, the VAT should not be oversold as a simple tax.

VAT Concepts and Mechanics

To grasp the probable techniques for nonneutral and complex treatment under a credit method VAT, its concepts and mechanics must first be understood.

The concept of a VAT is straightforward: A tax is imposed on the value added at each stage in the production and distribution of goods and services. Each fully taxable person along the production and distribution chain pays a tax on the value that he or she adds to the product. (Hereinafter, the person who collects and remits the VAT will be called a "taxable person" or "taxpayer.")

Liability under the credit method VAT, as applicable to fully taxable profit-seeking activities of a person, is determined by the following formula:

\[
\text{VAT to Be Remitted} = \text{(i.e., Rate } \times \text{ Sales)} - \text{VAT Paid on Purchases (or Refunded)} \]

Assuming that all businesses are fully taxable and that a uniform rate is applicable, the following observations concerning the calculation of a fully taxable person's VAT liability under the credit method may be made:

- The VAT is levied on sales (the price at which goods or services are sold), and the seller is the taxpayer.
• To avoid double taxation, a credit for the VAT on purchases is generally given to the taxpayer but not the ultimate consumer. This credit is generally available even if there is a net refund and even on purchases of capital goods and unsold inventory.9

• The tax is levied at a proportional rate on each transaction and not at progressive rates.

• The VAT is imposed at each stage of production and distribution, including the retail stage, making the tax multistage and comprehensive.10

• The amount of value added is not directly determined under the formula. In general, however, the amount to be remitted under the credit method VAT approximates a tax imposed on the value added by each fully taxable person (that is, the result under a tax on profits, increased by wages, rent expense, depreciation, and cost of inventory sold and decreased by capital expenditures and inventory acquisition cost).11

Flexibility of the credit method VAT could be introduced at almost any part of the formula (for example, the rate applicable, the timing of remittances, the taxable status of a person, the taxation or nontaxation of the sale, and the availability, timing, and amount of the credit).

**VAT Rate Flexibility**

In general, the higher the rate on an activity, the greater the impact of the VAT on business decisions. Thus, the VAT will have a proportional effect on business decisions, such as those relating to cash flow and to the possible denial or deferral of credit for VAT on purchases.12 In addition, because the incidence of the VAT among businesses and customers could influence pricing decisions and the decision to expand or contract operations, the ability to vary the VAT rate (or rates) reflects a power to influence these decisions.13

**Multiple Rates**

Multiple rates are common under a VAT. In the Federal Republic of Germany, for example, there is a standard rate of 14 percent and a reduced rate of 7 percent,14 while France has a standard rate of 18.6 percent and three other rates.15 This pattern is typical for all but two of the countries of the European Economic Community (see appendix A). Only the United Kingdom and Denmark have one rate (other than a zero rate).16

The existence of multiple rates at the retail level discriminates among VAT activities, whether or not imposed at prior levels.17 To the extent that the VAT affects profits for a type of business activity (that is, because the activity has to bear the incidence of the VAT), differential VAT rates would affect decisions to enter or leave the activity and to expand or contract operations. The imposition of a reduced rate or a reduction in the tax base in conjunction with the standard rate will ordinarily favor the activity.

A rate higher or lower than the standard rate principally affects only the cash flow of fully taxable activities if it is imposed at an intermediate stage (or at intermediate stages) and not at the retail level.18 In such a case, there is generally a catching-up effect in the next stage(s) and the total tax collected is equal to, or approximates, the amount that would have been collected if the retail rate had been used for all transactions.19

**Zero Rating**

The VAT rate at any particular stage can be zero, which in effect imposes no tax on sales but grants a credit for a tax on purchases. Because a zero rate is a rate just as is 5 percent or 10 percent, the effect of a zero rating of domestic sales would depend on the stage at which it is imposed. Thus a zero rate at the retail level (or at all levels) of an activity would generally
remove the VAT from that activity. Zero rating of this nature is used extensively in the United Kingdom.\textsuperscript{20} In contrast, zero rating at levels other than retail would principally give cash flow advantages to taxpayers.\textsuperscript{21} (Zero rating of exports is discussed in the section titled "VAT and Foreign Trade.") While zero rating is generally applied to sales \textit{by} an activity, it could also be applied to sales \textit{to} an activity. For example, a sale of expensive medical equipment to an exempt hospital entity could be zero rated.\textsuperscript{22}

\textbf{Backdoor Zero Rating}

Goods and services furnished to employees as fringe benefits could be subject to the VAT, as could goods and services furnished by a business as gifts or prizes, including advertising samples.\textsuperscript{23} However, these items are in effect zero rated if such goods and services are not subject to the VAT when granted, if they would otherwise be subject to the VAT on their purchase by the recipient, and if the granting business is given a credit for purchase VAT relating thereto.\textsuperscript{24}

An efficient approach to taxing goods and services furnished as employee fringe benefits and as business gifts would be to impose the VAT only on employee fringe benefits that are taxed to employees and on business gifts in excess of a threshold value such as $25.\textsuperscript{25} Such an approach, however, would encourage the furnishing of those goods and services that are not taxed. In particular, this approach would add to the considerable federal income tax advantages of advertising gifts that build goodwill\textsuperscript{26} and of certain employee fringe benefits,\textsuperscript{27} thereby potentially distorting economic decisions.

\textbf{Cash Flow Effects of the VAT}

Significant features of the VAT are the cash flow effects of receipt of sales VAT, the payment of purchase VAT, and the remittance of VAT to (or refund by) the government, just as the cash flow effects of the timing of income and deductions are significant features of the income tax.

The overall cash flow effects of VAT on businesses will usually be favorable because there is generally a delay of remittance of VAT collected. However, the effect of a VAT on each taxpayer's cash flow depends on many factors, including the use of the accrual method or the cash method, the length of the taxable period, the time for making remittance of the VAT, the amounts of cash purchases and sales, and the amounts and terms of credit purchases and sales.

\textbf{Accrual vs. Cash}

VAT would affect cash flow differently depending on whether the taxpayer determines liability for the tax through an accrual method or cash method.\textsuperscript{28} Under the accrual method, the taxpayer is generally liable for VAT on sales no later than the time an invoice is rendered\textsuperscript{29} and similarly gets VAT credit on the basis of invoices received. In contrast, under the cash method, the taxpayer accounts for sales VAT upon receiving collections but gets no credit for purchase VAT until payment is made.

The \textit{cash} method would be favored under the VAT in circumstances similar to those for the income tax. Thus, the cash method might be preferred simply because it ensures that a VAT will not have to be remitted to the government until cash is available. The cash method would be particularly favorable when there are significant credit sales in comparison with credit purchases or when receivables turnover is slower than payables turnover.\textsuperscript{30} Use of the cash method by a taxpayer could therefore affect the taxpayer’s sought terms for sales and purchases. The cash method could have advantages for small business, in part because this method may be less costly to use than the accrual method and in part because the cash method could confer cash flow advantages and could therefore be made specially available to it.
The cash flow position of the *accrual* method taxpayer would depend largely on the credit terms of his or her sales and purchases. The accrual method would generally be favorable when credit sales are not significant and credit purchases are significant.\(^{31}\) The accrual method would also generally be favorable in the case of significant credit sales and purchases, when receivables turnover is faster than payables turnover. The accrual method taxpayer would have an incentive to compensate for any cash outflow problems by favoring cash sales over credit sales or by making credit sales requiring relatively quick payment. Alternatively, in some cases the taxpayer might prefer leasing goods to customers over selling. Similarly, the taxpayer would be encouraged to make purchases with long payment terms and to defer short-term credit purchases and thereby reduce average inventory levels.\(^{32}\)

When the buyer and the seller use different methods, the VAT may affect the terms of the sale. If the buyer uses the accrual method and the seller the cash method, the VAT offers the buyer a special incentive to make a credit purchase from the seller while offering no comparable incentive to the seller. Conversely, if the buyer uses the cash method and the seller the accrual method, the VAT offers the seller a special incentive to make a cash (or short-term credit) sale to the buyer while offering no comparable incentive to the buyer.

**Bad Debts**

Bad debts create a problem under the accrual method because the seller often remits to the government the VAT on a credit sale before the seller collects it from the customer. If the receivable ultimately proves to be uncollectible, the seller will sustain a real loss unless he or she is permitted a refund of the VAT remitted or an allowance credit for estimated uncollectible taxes on sales. If such a refund or credit is not permitted, the seller will have an additional incentive to modify the terms of all or some sales in order to minimize possible bad-debt losses. If a refund or credit is permitted only if the purchaser becomes bankrupt (formally insolvent), as in the United Kingdom,\(^{33}\) the seller would have an incentive to force the purchaser into bankruptcy.

**Deferred Payment Sales and Purchases**

The availability of an installment method for remittance of VAT on deferred payment sales could affect the frequency of such sales.\(^{34}\) Further, if only certain deferred payment sales qualify for the installment method (such as those involving retention of title or of a security interest in the property by the seller), there would be an incentive to the seller to make such qualifying deferred payment sales in preference to nonqualifying deferred payment sales.

Similarly, the timing of the purchase VAT credit on deferred payment purchases could affect the frequency and type of such purchases. If the purchaser is given a present credit for purchase VAT on some or all deferred payment purchases, the purchaser will favor the use of such purchases.

Of course, any type of deferred payment sale and purchase that qualifies the seller for the installment method for VAT on the sale but enables the purchaser to take a present credit for VAT on the purchase may be favored by the parties.\(^{35}\)

**Vertical Integration**

An integrated business under one corporate shell might have a cash flow or other advantage over competing nonintegrated businesses because it would delay any VAT remittance to the government until sales are made to outsiders.\(^{36}\) The cash flow advantages for integrated businesses would encourage a business to supply its own taxable goods and services instead of purchasing them from third parties.\(^{37}\) The VAT could thus be one of the many factors encouraging corporate combinations that involve vertical integration.
Group Registration

Because of the potential cash flow advantage of an integrated business under one corporate shell, related businesses are often permitted to elect treatment as one entity for VAT purposes, thereby achieving, in effect, a VAT consolidated return. If group registration may be made only by corporations, and not between an incorporated and an unincorporated business (and if only unincorporated businesses with identical ownership may have a single registration), as in the United Kingdom, there will be an incentive to organize taxable businesses in a form that facilitates group registration or treatment as one taxpayer (for example, as corporations). If group registration is not permitted, there will be an incentive to avoid multiple corporations for a vertically integrated business by the same ownership interests.

Tax Periods

The length of the taxable period and the time thereafter for payment will affect cash flow. In the United Kingdom the period is three months, with the return being due within one month thereafter. The U.K. approach could give significant cash flow advantages. For example, assuming cash sales and purchases are made ratably throughout the tax period, the U.K. approach will give the taxpayer two and one-half months’ use of the net tax payable before required remittance.40

Moreover, an optional shorter period, such as one month (as in the United Kingdom) could be made available for a taxpayer (or affiliated taxpayers under a group registration). Such a period would be appropriate if the taxpayer (or group) were typically in a net repayment position (that is, his or her credits exceed tax on sales).

An optional shorter period would encourage an individual with two businesses, one typically in a net repayment position, to incorporate one of the businesses (or each of the businesses) in order to have a short period for the business in a net repayment position and a regular period for the other. Similarly, a corporation with two such businesses (as divisions) would be encouraged to place one of them in a subsidiary.42 If two group registrations were permitted for multiple related corporations (one for those corporations using the standard period and the other for those electing the shorter period), as in the United Kingdom, there would be an additional incentive for multiple corporations.44

Exemption

An activity could be exempted from the VAT. This technique is used extensively in the United Kingdom to cover both profit-seeking and non-profit-seeking activities such as finance, insurance, education, and charities. With exemption, as with zero rating, sales are not taxed. Unlike zero rating, however, no credit is allowed for taxes paid on purchases; that is, purchase VAT credit is denied.

Exempt status may exist other than explicitly. For example, employees generally have an exemptlike status because they generally do not charge tax on their services for the employer and are not permitted a credit for taxes paid on employment-related purchases. Similarly, if a business or other activity is neither required nor allowed to register as a taxpayer, it also has an exemptlike status.

Effect

An exempt or exemptlike status for sales at other than the retail level would hamper an activity according to the relative amount of purchase VAT because the business or other activity would be forced to absorb, or pass on to any taxable customers, the noncreditable purchase VAT. As an example, if financing activities are exempted, the financing source
(whether a bank, an insurance company, a savings and loan association, a pension fund, or an individual) and the type of financing (whether equity or debt) that has the smallest VAT on purchases to absorb or shift forward is given one type of competitive advantage which could be significant. Thus, the VAT could conceivably affect the financing decisions of business firms. Similary, if leasing is fully taxed but other financing is exempted, another economic distortion would be created. Not only might taxable leasing and other (exempt) financing have different VAT content in sales to shift forward to purchasers, but the VAT content in leasing would also be potentially creditable to business purchasers while the VAT content in other financing charges would not be.

An exempt or exemptlike status at retail level probably would not hamper an activity, because the retail consumer is not entitled to a credit. Instead, this status at the retail level is likely to be advantageous, particularly when the amount of purchase VAT is relatively small and labor is a substantial element in the goods or services sold.

**Tax Avoidance**

*Response by Taxable Customers.* Exempt or exemptlike status of an activity would encourage its potential taxable customers to minimize purchases from it in one or both of the following ways: First, taxable potential customers would be encouraged to self-supply to replace all or part of potential purchases from the exempt activity. For example, if university graduate education is exempt from the VAT, a business might prefer developing its own technical education program to receive credit for any VAT on purchases instead of utilizing university services that have a VAT content but not in creditable form. Conceivably, a business could also be encouraged to finance its activities through retained earnings in place of borrowing funds if finance were exempt, or to self-insure if insurance were exempt.

Second, taxable potential customers would also be encouraged to seek a registered (taxable) supplier to replace all or part of potential purchases from the nonregistered (exempt) supplier and, in particular, to limit the role of the exempt supplier to the furnishing of services with minimal VAT content.

*Response by Exempt Activity.* Exempt or exemptlike status of an activity would encourage the activity's tax avoidance in one or more of the following five ways: First, the exempt entity would have an incentive to minimize its taxes on purchases of both capital and noncapital items by self-supply. For example, an exempt insurance company might furnish its own janitorial services instead of hiring an outside concern. Self-supply could be discouraged by being taxed as a separate activity, but such an approach presents significant difficulties in identifying and valuing the self-supply to be taxed. In the United Kingdom, until recently only the self-supply of printing by exempt activities was subject to taxation. However, now that nonresidential construction is subject to the VAT in the United Kingdom, the self-supply of building services by businesses is also taxed in the United Kingdom.

Second, the exempt entity would also have an incentive to minimize its taxes on purchases by having its customers deal directly with taxable suppliers. The exempt entity would attempt to limit its activities to the performance of services on which it has minimal purchase VAT. Thus, if insurance is exempt, the insurance company should reimburse the insured for damages to property but should not contract for the repair of the property. (A variation of this technique will be used by employees and by unregistered businesses, as discussed subsequently.)

Third, the exempt entity would be encouraged to minimize cash flow problems relating to the denial of the credit on necessary capital assets by leasing the assets, by deferred payment purchases of such assets, or through similar financing techniques. These techniques might be
available to defer payment of the denied credit. For example, in a lease to an exempt entity the VAT might not affect the lessor's credit for the leased assets. Because the lessee/exempt entity will be charged VAT as lease payments are made, there will be a deferred denial of the credit to the exempt entity. Similarly, in the deferred payment purchase, the VAT may require the seller to remit the VAT only as payments are received, thereby also resulting in a deferred denial of the credit.58

Fourth, the exempt entity will be encouraged to acquire high-cost assets by the tax-free acquisition of target companies owning those assets, followed perhaps by a lease of the assets from the subsidiary to the parent.59 Similarly, the exempt organization could organize a taxable subsidiary in the business of leasing such assets and the parent would be one of its customers.

Fifth, if an exempt corporation purchases goods or services from a taxable related corporation, the two will be encouraged to make a group registration (if permitted), to avoid noncreditable tax being charged the exempt corporation by the taxable related corporation. If a group registration is not made or permitted, taxable goods and services would undoubtedly be supplied at the minimum charge;60 there would also be an incentive to combine the taxable activities under one corporate shell.

**Employees**

Because an employee's employment is not a taxable activity, the employee is not able to receive credit for purchase VAT relating to his or her employment (such as VAT arising out of (1) purchase of tools and equipment; (2) transportation, meals, and lodging while away from home; (3) entertainment; and (4) special uniforms). This treatment of the employee concerning employment-related costs could encourage the employee to incorporate his or her economic activity, with the corporation incurring the taxable costs. The cases in which such incorporation would be appropriate and be given tax recognition would not be frequent.61 A VAT could affect the form of employer reimbursement or extra compensation for employee costs and expenses. It encourages the employer to pay these costs and expenses directly or to reimburse the employee in a creditable form,62 rather than doing so indirectly by increasing employee salaries or payment in another, noncreditable form.63

**Registration**

Many VAT systems require registration by only those businesses that reach a threshold level of economic activity.64 In the United Kingdom, a taxpayer generally need not register unless annual sales reach, or are expected to reach, £23,600 (approximately $39,400).65 Because the exemptlike status of nonregistration is generally advantageous at the retail level,66 retail businesses can be expected to attempt to avoid registration, particularly when the labor content or profit on their goods or services sold is high or when both the labor content and profit are high. For example, a business could limit its sales to services and require that its customers purchase directly any necessary third-party taxable supplies. This pattern might become typical for home improvements and repairs, appliance repairs, and automobile repairs performed by independent contractors. As a second example, a retail business selling goods could convert to a sales agent status, performing only services for the distributor or supplier. Thus, a part-time repairer and seller of used violins would be encouraged to make sales on commission and not purchase for resale. As a third example, a manufacturer would be encouraged to distribute its products through numerous part-time salespeople selling out of their own homes or door-to-door.67 A fourth example involves the division of a business to separate a retail activity (which presumably would not need to register because of its size) from other activities, either by transfer to a related individual or by incorporation.68
Prebusiness Costs

A barrier to entry into a new business or to the organization of a business will be created, unless prebusiness taxable purchase VAT is creditable.69 Possible prebusiness taxable costs would include investigation costs and organization costs.

Partial Exemption

If a taxable person conducts one or more exempt activities in addition to one or more taxable activities, purchase VAT credits will have to be apportioned between the taxable (creditable) and the exempt (disallowed). The rules for apportionment could affect methods of accounting and identification of cost centers,70 either because the taxpayer would like to use similar methods for VAT and for financial-managerial purposes or because the government follows the taxpayer’s non-VAT approach in determining the VAT result.71 Rules for apportionment conceivably could affect such business decisions as whether to form one corporation (partially exempt) or two (one exempt and the other taxable).72 Similarly, the availability of a de minimis rule that permits full utilization of credits when exempt sales do not exceed a certain proportion of total sales could also affect the form of organization. Further, the use of unsophisticated apportionment techniques, such as apportionment based on current year’s sales73 instead of eventual use of the purchased goods or services, could encourage timing of purchases so that the purchase VAT credit is taken in a favorable year.

Alternative VAT Methods

Certain activities may be permitted or required to use a noncredit VAT form, although business may generally use the credit VAT form.74 The permitted or required noncredit VAT form would determine VAT liability under one of the following basic formulas:

\[
\text{VAT Liability} = \text{Rate} \times (\text{Sales} - \text{Taxed Purchases})
\]

or

\[
\text{VAT Liability} = \text{Rate} \times (\text{Profits} + \text{Deductions Not Otherwise Subject to VAT})
\]

The effect of such an alternative VAT form when businesses are generally using the credit form is to impose one aspect of exemptlike status. The activity has no credit for taxed purchases. At the same time, the activity has VAT imposed on its own value added, but in a form that does not give rise to a credit to its taxable customers.

The use of a noncredit VAT form by a business at the retail level would theoretically not give it a competitive advantage or disadvantage over a taxable competitor using the credit method, assuming that the incidence of any VAT imposed remains the same. However, use of a noncredit VAT form by a business at a nonretail stage would be especially disadvantageous because it would increase the amount of noncreditable VAT.

Use of an alternative VAT form is often permitted to small businesses76 in order to minimize administrative and compliance costs. For the reasons noted previously, the election is likely to be made only by a business with insubstantial nonretail sales. The form of business organization may be dictated by the availability of the election because an owner may set up a retail business in a different entity than a nonretail business in order to make the election only for the retail business.

Use of an alternative VAT form is required in the European Economic Community (EEC) in the case of the EEC business of “tour operators.”77 The purpose of this requirement is in part to modify the results of the destination principal VATs within the EEC, under which the country in which goods and services are purchased for ultimate consumption benefits from all the VAT on those goods or services.78 Because of the special status of tour operators, a southern European country such as Spain need not grant a credit to a U.K. tour operator for hotel and
other taxable purchases in Spain. In effect, this required use of the alternative VAT form modifies the EEC destination approach in favor of an origin approach. Unfortunately, the EEC rules for tour operators apply to their EEC nonretail sales as well as to their EEC retail sales, providing incentives for businesses to avoid the noncreditable purchase VAT.

The EEC experience with tour operators may be important for the United States if a federal credit-form VAT permits the states to piggyback their own VATs onto the federal VAT and if administrative and compliance considerations dictate that a destination principal credit-form VAT be used. In such a case, the required use of an alternative VAT form by a retail business would ensure that its out-of-state purchases would give rise to a VAT that benefits the state of its supplier. Such an approach at the retail level might be useful to preserve the revenue of a state that is significantly dependent on the manufacture and wholesale distribution of one commodity, such as automobiles. It could also be used to preserve the revenue of a state with significant hotel bookings.

**Used Capital Assets**

Because the capital assets of an exempt activity have previously borne VAT (if purchased after enactment of the VAT), resale of such assets by the exempt activity raises double-taxation problems with accompanying economic distortions. Existing solutions, discussed in chapter 4, are not entirely satisfactory.

**The Credit**

The allowance of a credit for the purchase VAT of a taxable activity is an integral and essential part of the credit VAT form. The shaping of the rules for allowance and denial of the credit, however, offers considerable flexibility. This flexibility in turn offers considerable opportunity for an impact on business decisions. This section will discuss the credit in general, whereas the next section will focus on the credit on capital goods.

**Excess Credits**

Purchase VAT that is potentially allowable as a credit might exceed sales VAT when there are zero- or low-rated sales, relatively small standard rated sales, large capital expenditures, large inventory purchases, or a combination of these conditions. European practices vary considerably in dealing with such excess credits. At one time or another, various countries have allowed the excess credit in full as a refund (as in the case of exports generally), allowed it in full when it reached a minimum amount, or allowed it only to offset subsequent taxes on sales. To minimize fraudulent claims, the taxpayer may be required to have established a business history. The credit could conceivably also be carried back to offset the VAT liability of prior years and be allowed currently to that extent. In addition, the government could vary general treatment of the excess credit according to considerations of overall economic stabilization policy or could favor or penalize particular activities by permitting different treatments among activities. It is apparent that deferring use of the credit would present the taxpayer with a cash flow problem and encourage the taxpayer to take steps to avoid an excess credit.

If a business with excess credits is organized as a partnership, the excess credits might be allowable only to the partnership and its successors. If a conduit theory were utilized, however, each partner could offset his or her distributive share of excess tax credit against the current tax liability from the partner’s other taxable activities or against the subsequent tax liability of the partnership or some other taxable activity. Allowance of a similar credit to the shareholders of a corporation would probably not be permissible, except in the case of corporations that are comparable to the present S (pass-through) corporations. The choice of business organization would therefore affect cash flow.
If an activity with excess credits were organized under the same corporate shell as an activity with VAT liability against which the credits could be offset, the corporation would have a cash flow advantage over two similarly situated activities organized under separate, related corporations and over two similarly situated unrelated corporations. Thus, unless related corporations could obtain a current offset through a group registration privilege, there would be an incentive under the VAT to combine all activities under one corporate shell. Unrelated corporations and other entities would still not enjoy the cash flow advantage available to related corporations and other entities unless the system did not allow the offsetting of excess credits against liabilities either among the divisions of a corporation or among related corporations.

A related problem is whether it should be permissible to acquire a corporation in order to take advantage of its deferred credit potential. To allow use of the credit in these circumstances would encourage corporate acquisitions.

The form of business organization might affect the ultimate allowance of a deferred credit arising out of an excess credit or out of an unamortized credit from a capital acquisition. If a corporation has such a credit, the death of a shareholder would not seem to affect the ultimate allowance of the credit, yet termination of the business and dissolution of the corporation probably would. On the other hand, if an individual has a deferred credit through a proprietorship or a partnership, the individual’s death would seem to affect the ultimate allowance of the credit but a change in business activities probably would not. The problem in part is whether an excess credit can be assigned to specific property and, if so, whether transfer of the property should also transfer the excess credit when consideration for the transfer might or might not be involved. A similar problem arises with a change of the organizational form of a business (for example, the incorporation of a partnership). Failure to allow the new organization the benefit of a potential credit will discourage changes in the form of organization.

**Delayed Credits**

Purchase VAT could be delayed as a credit. Under one approach, purchase VAT would not be creditable at the time paid or incurred, but only after a specified period, such as one week or one month. Such a lag in credit would confer a cash flow advantage on the government and could be imposed generally for budgetary reasons or selectively for various reasons. Under another delayed credit approach, purchase VAT of an accrual method taxpayer would be creditable only when paid, as in the case of a deferred payment purchase. This approach might be used to ensure that a purchaser and his or her seller were using the same timing rules for the VAT on the transaction. Delayed credits would generally present the same problems and opportunities as excess credits not presently allowable.

**Denied Credits**

Credits on certain taxed purchases of an entity could be denied. There could be a denial of a credit for purchase VAT on taxed expenses (in contrast to a capital costs) (1) in pursuit of a social policy to discourage incurring of the expense, (2) in recognition of substantial personal enjoyment in such expense and the difficulty of separating profit seeking from pleasure, (3) in an attempt to offset favorable income tax treatment, or (4) for a combination of these reasons. In the United Kingdom, for example, purchase VAT on entertainment expense does not qualify for the credit, perhaps because the United Kingdom recognizes the substantial personal enjoyment in entertainment.

The denial of a credit for purchase VAT on an expense creates an incentive for taxpayers to avoid the expense, to self-supply the goods and services involved so as to minimize denied credits, or both.
Limited Credit Amount

In narrow circumstances, it would be appropriate to limit the amount of the credit of an activity for its purchase VAT either for all costs or for expenses. Limitations on credit amounts arising out of a covered activity carried on by a taxpayer would be imposed even though the taxpayer does not have excess credits from all taxable activities.

The limiting of the credit amount in an activity might be useful if profit-seeking motives do not or may not predominate, as in agriculture, horse breeding, horse racing, and automobile racing. For example, in a case in which a ranch is carried on as a hobby, the credit for purchase VAT on expenses (but not capital items) could be limited to a percentage of sales (such as 80 percent), which percentage would be set by statute or regulations and based on the assumed ratio of purchase VAT to sale VAT in similar businesses carried on for profit. Excess potential credits for purchase VAT on expenses would not carry over. Credit for purchase VAT on capital items might also be limited to sale VAT, reduced by purchase VAT on expenses, but could carry over to subsequent years.

The limited credit amount rewards efficient operators and penalizes inefficient ones. It also penalizes operators who have low receipts because of conditions beyond their control. The limit, if set high, could encourage investment in an activity, at least in the short run. If set low, it could discourage investment in the activity at least in the short run.

Substituted Credit

A similar approach would be to impute a credit as a substitute for the credit on actual purchase VAT on expenses or all costs of an activity. For example, EEC countries are authorized by EEC law to base a farmer’s credit on a percentage of the farmer’s sales regardless of the presence or absence of a predominant profit-seeking motive.84 Such a credit replaces the actual credit.

A substituted credit would generally seek to approximate the purchase VAT on expense (or on all costs) based on industry experience for the entire industry or for broad groupings within the industry (by size or product). The substitute is thus a grant of a credit. Although the credit granted could limit an activity, it could also be larger than the actual purchase VAT covered.

The effect of the substituted credit on taxpayers and their behavior would be similar to that of the limited credit.

Additional Imputed Credit

It is feasible in a VAT system to grant an imputed credit to taxpayers. The VAT system could allow an imputed credit in a variety of situations. The first of these situations is an imputed credit for purchases from an exempt stage. An imputed credit can be employed to alleviate certain problems associated with exemption of an activity from the VAT at stages other than the retail stage. Because the VAT on purchases by an exempt activity is not creditable to it, it may seek to shift this cost forward to its customers. Granting an imputed credit to customers of the exempt activity is one technique to keep the customer of the exempt activity from absorbing the noncreditable VAT content of his or her purchases from the activity and to make the customer willing to pay a purchase price that includes the noncreditable VAT content.85

European countries have used such a technique when agriculture is an exempt activity,86 but the technique could also be used for other exempt activities such as insurance. In the context of agriculture, the processor who purchases agricultural products from an exempt farmer receives an imputed credit representing the estimated VAT paid on the products by the exempt farmer. This imputed credit could be unrealistically high, with the intention of subsidizing production of food. Varying the rate of the imputed credit from time to time could affect the price paid to farmers and thereby encourage them to sell their produce or hold it for future sale. In addition, if the farmer does not obtain a direct tax credit but would perhaps get
an indirect benefit from the imputed credit, the farmer would be encouraged to delay payment of VAT on purchases of productive assets by lease or deferred payment purchases and to minimize taxes on purchases through self-supply. The system might even give established farmers a competitive advantage over those entering farming or expanding existing operations or give efficient farmers a competitive advantage over inefficient ones.

Although an imputed credit that was generally available to businesses purchasing from an exempt stage might discourage the purchasing business from self-supply, it probably would not entirely prevent the tendency of exempt entities to delay imposition of taxes on purchases or to self-supply.

Second, an imputed credit could be granted to encourage certain classes of expenditures. Such an imputed credit, in addition to the regular purchase VAT, would encourage incurring of costs giving rise to the credit, at least in the short run. Examples of such potential credits include—

- Wages expended for research and experimentation.
- Discovery value in mineral properties.
- Rehabilitation of low-cost housing or historical structures.
- Wages paid to the hard-core unemployed.
- Payments to retirement plans.\(^{87}\)

This class of imputed credit would be essentially equivalent in function to the various income tax credits.

Third, an imputed credit could be used to promote progressiveness in the VAT. For example, progressiveness could be sought through the grant of a credit to a taxable employer for his or her reimbursement to an employee of the employee's social security taxes on a specified amount of wages.

Finally, an imputed credit could be used to avoid double taxation on used goods.

**Used Consumer Goods**

Many taxable businesses deal in, and even rebuild, used consumer goods such as automobiles, refrigerators, violins, computers, and automobile parts. The imposition of a full VAT on resale by a business will potentially discriminate against used goods and in favor of new goods, assuming that these goods had previously been taxed under the VAT. An imputed credit and several other solutions (discussed in chapter 4) are possible to avoid or mitigate double-taxation problems, but these solutions are not entirely satisfactory.

Failure to prevent double taxation on used consumer goods will encourage tax avoidance in many cases. For example, the business otherwise purchasing and reselling the used goods will be encouraged to render any services on behalf of the original owner (for example, to take the goods on consignment or as a selling agent).

**Capital Goods**

The purchase VAT on business and investment capital expenditures and on consumer durable goods presents special problems.

**In General**

In the European countries employing a VAT system, economic policy considerations generally dictate the allowance of a credit for purchase VAT on business and investment capital expenditures.\(^{88}\) The credit encourages expansion of capital facilities, thereby stimulating
economic growth. Such a credit also serves to remove a potential discrimination against new capital goods vis-à-vis old capital goods, although the discrimination could also be avoided by imposing the tax on capital goods that exist when the VAT is adopted.

Credit Denial

The power to grant or deny a credit on capital expenditures for business and investment purposes is a significant aspect of VAT flexibility and hence a potential source of nonneutral economic impact. A denial of the credit on all capital goods would clearly discourage their acquisition. This might be done deliberately for a number of reasons (for example, to dampen inflationary pressures on the economy).

A denial of the credit on selected capital goods is also a possibility. Political pressures emanating from loss of jobs in a particular industry due to mechanization might lead to selective denial of the credit. Such a denial is also a possibility for the same reasons given for a denial of the credit on purchase VAT on selected expenses. In the United Kingdom, for example, purchase VAT on automobiles and on entertainment facilities acquired for use and not for resale is denied, apparently to avoid distinguishing between business and personal use, to raise additional revenue, and (in the case of automobiles) to offset favorable income tax rules. In the United Kingdom, the denied credit technique is therefore used sparingly. The denied credit technique could be used in the United States to deal with costs that have mixed business and personal uses, involve considerable VAT or income tax avoidance or evasion, or include both characteristics.

Denial of the credit on purchase VAT for selected capital expenditures would encourage firms to take a number of steps. One step would be for firms to construct their own capital assets if such self-supply is not subject to VAT. In the United Kingdom the self-supply of automobiles is subject to VAT, but certain improvements thereto are not. Furthermore, the self-supply of certain construction services is subject to VAT in the United Kingdom.

Another step would be for firms to purchase used assets, assuming that the used goods are not subject to a second tax, with the effect that used goods would become more valuable. If used goods were subject to a second VAT, firms would be encouraged to enter into exchanges of equity interests for capital assets, unless these transactions were subject to the VAT, and such reorganizations could have as much tax significance under a VAT system as under the present income tax system.

As another step, firms could lease goods, assuming that the lessor's credit is not denied. Credit denial to the user would thus be deferred until rentals are paid. Therefore, the lessor's credit should also be denied. In the United Kingdom, for example, the lessor's credit on purchase VAT for automobiles is denied. Nevertheless, the full denial of credit for purchase VAT on business automobiles in the United Kingdom has provided businesses with an increased incentive for leasing, rather than purchasing, automobiles. Such denial increases the price cost advantage of any discount given lessors for volume purchases by the rate of the VAT. If a business firm could purchase an automobile for $10,000 and a lessor could purchase the same automobile for $9,000, assuming a VAT of 15 percent, the firm's purchase VAT would be $1,500 while the lessor's would be only $1,350. The lessor's price advantage has thus been increased by $150 to $1,150.

A final step for firms to consider would be to minimize the cash flow problems that result from denial of the credit through installment purchases and similar financing arrangements.

Amortization

If a credit is allowed for purchase VAT on capital purchases, it could be currently allowed as an offset to tax liability or it could be amortized over the estimated life of the property or some other period. Amortization of the credit would generate nonneutral effects similar to those
resulting from a denial of the credit\textsuperscript{97} and would also create the problem of determining proper amortization methods.

Amortization of the credit for purchase VAT on capital expenditures over the life of the property or some other period might be required in one or more of the following situations:

- If the property is used in both exempt and taxable activities, the purchase VAT could be allocated between the creditable and the noncreditable uses by requiring amortization over some period and apportioning each year's amortized purchase VAT according to the relative use of the property in that year.
- In cases of likely (or even possible) personal use, amortization of the purchase VAT and apportionment between personal and taxable activities could be required.\textsuperscript{98}
- The government might use long-term amortization of the purchase VAT to discourage capital expenditures, as part of an anti-inflation policy or because of pressure from organized labor.

If the credit were generally allowed only over the life of the property, the government could use current allowance or accelerated amortization in specific cases to encourage an activity.

**Changed Use**

Dealing with changes in the use of capital assets will challenge the VAT and potentially give rise to complex rules. Capital assets might be held for (1) initial exempt or personal use, giving rise to no credit for purchase VAT on acquisition; (2) initial taxable (business or investment) use, giving rise to full credit on acquisition; or (3) mixed initial use, giving rise to partial credit on acquisition. Change of initial use is relatively common. An exempt domestic insurance company may convert an office building from exempt to taxable rental use, or vice versa. A person may convert a residence from personal to taxable use, or vice versa.

It is generally assumed that the VAT will grant a credit for purchase VAT based on initial use of property. Failure to recognize changed use will discriminate among properties and taxpayers, thereby making the VAT nonneutral, and will encourage significant attempts at tax avoidance. Under the current credit approach, failure to recapture a credit when taxable use of property declines in relation to exempt or personal use would discriminate against exempt or personal use property that had never been converted. Taxpayers would be encouraged to acquire property for initial taxable use with the plan to convert the property to exempt or personal use at a later date. Similarly, under the current credit approach, failure to grant a credit when exempt or personal use of property declines in relation to taxable use would discriminate against that property. This discrimination, among other things, would discourage persons from acquiring full ownership of property if initial exempt or personal use might change. In these circumstances, a person would be encouraged to acquire use of property by lease instead of purchase or by lease with option to purchase. The transaction might even be structured so that a related party purchases the property for lease.

There is no simple solution to the problem of changed use of capital assets. In the United Kingdom, the problem of changed use was ignored for a period. After almost twenty years of experience with the VAT in the United Kingdom, a satisfactory basic solution to the problem is not readily apparent and is being debated.\textsuperscript{99} Solutions discussed in chapter 4 are not entirely satisfactory.

**Used Capital Goods**

When used capital goods of a business are sold, these goods should ordinarily be subject to VAT at that time. However, if purchase VAT credit was denied on the original purchase of a capital asset (see previous section titled "Denied Credits"), imposition of a VAT on its
The VAT and Foreign Trade

European nations that employ a VAT system in effect zero rate exports so that these products do not bear the VAT of the exporting country. The VAT does apply to the purchase price (including freight and custom duties) of imports. The VAT on imports is therefore approximately the same as the VAT on local goods of the same price. The implementation of the destination principle (the country of destination and not the country of origin of the goods collects the tax) is achieved through the zero rating of exports, coupled with the full imposition of VAT on imports. A country following an origin principle would, conversely, tax exports but not imports and would grant a credit for all or part of any VAT taxes paid to another country on imported goods.

Some proponents of the VAT have argued that the replacement of the corporate income tax with a VAT system would improve the U.S. balance of trade. This dubious conclusion follows from partial equilibrium analysis on the assumption that the U.S. corporate income tax is shifted to the consumer. In the general equilibrium context, it is not clear what effects the VAT has on a nation's trade balance. The VAT does, however, offer a means by which the United States can attempt to affect the balance of trade by various bits of tinkering. The United States could penalize selected exports, for example, by application of a nonzero rate or by exemption. It could favor exports by zero rating purchases of goods and services by export houses, in effect giving a cash flow advantage.

Similarly, the United States could encourage or discourage imports by selective variation of the applicable VAT rate to a product line dominated by foreign sellers, such as caviar, wigs, and chromium. It could also encourage or discourage imports by the required time of payment of the VAT on imports. Because the VAT on imports by a business is creditable, any charge of such a VAT will principally affect cash flow. Thus, a failure to charge VAT on imports by a business, or the deferral of such a charge until the imports are resold, may give the imported product a cash flow advantage over the competing domestic product. Conversely, the imposition and required payment of VAT immediately upon import may give the imported product a cash flow disadvantage.

The availability of a procedure for avoiding VAT on goods imported for further processing (whether or not for domestic resale) and the resulting cash flow advantage may encourage (or at least not discourage) location of such processing activities in the United States.

Significant discretion apparently exists in the treatment of services. For example, the U.K. VAT, based on the EEC's Sixth Directive, zero rates exports of services of a specified nature but not of others and generally taxes imports of services of only the same nature. Although this approach could be justified on the grounds that the specified services are of the type most likely to be imported or exported, only the specified services are taxed by the United Kingdom under a destination principle. The remainder of the services are taxed under an origin principle.

Because a U.S. VAT would be free to adopt a destination principle or an origin principle for exports and imports of services, or a mixture of the two as in the United Kingdom (or even a destination principle for imports of services and an origin principle for all or part of exports), the approach chosen could favor one type of import or export of services over another and perhaps affect the composition of exports and imports of goods and services. If one assumes that the VAT is unlikely to affect the level of imports and exports, but only the composition thereof, Congress has a fiscal weapon of considerable importance.
A VAT Favoring Small Business

The VAT is sufficiently flexible to be structured to favor small business. A VAT system might, for example, cover or exempt small retail businesses at the election of each business. Although exempting a small retail business would deny the business a credit for taxes on purchases, its sales would not be subject to the tax. The retail business would therefore have to shift forward to the customers only its taxes on purchases and not a larger tax on sales. A VAT system could also favor small business by zero rating both sales to and sales by small businesses. 106 Zero rating the purchases of a business would mean that the business would not have the disadvantage of cash outflow for taxes on purchases. Zero rating the sales of a business would mean that customers would not be required to pay for the tax on those sales, which could give the small business a selling advantage over other businesses. In addition, a VAT system could favor small business (to the extent subject to the VAT) by permitting each small business to elect to use the cash method, thereby potentially affecting its cash flow favorably. 107

An Industry Example

Consideration of a particular activity—exploration and development of oil and gas wells—will further illustrate the potential nonneutrality of a VAT system. The VAT could be structured to encourage such exploration and development by allowing a current credit for all taxes on purchases for exploration and development. The system could allow an imputed credit several percentage points above the actual tax rate and could grant the credit currently, even though it is in excess of tax liability. An imputed credit, amortized over the life of the well, for the discovery value of a producing well, could also be used. A similar rule could apply to the amortization of an imputed credit on the value of producing wells in existence when the VAT was enacted. The system could allow a taxpayer who purchased a producing well after enactment of a VAT a credit for the VAT on the purchase and could give the taxpayer the alternative of receiving the credit immediately or amortizing it over the life of the property. To avoid the complexity of valuing the producing property to determine the allowable tax credit, the system could reduce the taxable base on sales of petroleum products by some percentage or subject sales of petroleum products to lower rates than the standard rate. Such a scheme would encourage the exploration and development of oil and gas wells, at least in the short run, and would play a role quite similar to that played by the preferences the present income tax laws108 grant the oil and gas industry.

Conclusion

While the VAT in theory is a neutral tax, Congress might take advantage of its flexibility to mold it into a highly nonneutral tax. Many of the potential effects on operating, financing, and organizing decisions of business firms that are described in the foregoing pages would characterize a U.S. VAT system in such a case. Nevertheless, Congress could make a deliberate effort to shape the implementing rules and regulations to avoid a major impact on business decisions, to operate efficiently, and to have other desirable attributes.
Chapter 2

DESIGN CRITERIA FOR A VAT

The following objectives (including economic neutrality and efficiency) for a U.S. VAT, in possible order of importance, are suggested for consideration:

1. Adequate tax yield.\(^{109}\)
2. Realistic tax burden—the imposition of a burden that can be conveniently paid by consumers and remitted by business and that is not so excessive as to encourage substantial distortion of the VAT base through taxpayer avoidance or encourage the search for legislative preferences.
3. Cost efficiency—the minimization of government administrative costs and taxpayer compliance costs.\(^ {111}\)
4. Effective prevention of tax avoidance.
5. Economic neutrality—a minimal distortion of economic decisions through the tax.
6. Fairness—similar treatment of similarly situated taxpayers.
7. Design and administration of the VAT to foster taxpayer attitudes that the VAT is a fair and efficient tax.
8. Accomplishment of social, economic, and political goals.\(^ {112}\)

These objectives are often conflicting. For example, if extensive use is made of the VAT to accomplish social, economic, and political objectives, accomplishment of many of the other objectives may be impossible.

The value of cost efficiency, anti-avoidance effectiveness, and perception of fairness in the design criteria will be recognized by certified public accountants (CPAs) and others concerned with tax administration and compliance.
Chapter 3

DESIGNING FOR COST EFFICIENCY

A principal goal for any VAT for the United States will undoubtedly be that it be efficient, thereby minimizing the government's administrative costs, taxpayer compliance costs, and other problems. Efficiency in a U.S. VAT is particularly desirable because this VAT apparently would not replace the complex federal income tax on corporations and individuals. Nor would the enactment of a VAT be used as a justification for removing any layers of complexity in the federal income tax. Efficiency in a U.S. VAT is desirable also because the VAT has considerable potential for complexity (see chapter 1). If a VAT is designed with efficiency as a goal, perhaps the VAT could escape the fate of the present federal income tax, which is overwhelmingly complex and riddled with special provisions. Moreover, if incentives or other special provisions incorporating social, political, or economic objectives are to be adopted, the most efficient alternatives could be used (see chapter 4).

It is not certain that efficiency will begin and remain as a clear and principal objective of a U.S. VAT, but if a VAT is adopted in the United States, CPAs will work for efficiency in a U.S. VAT.

Accordingly, the following approaches are suggested for design and administration of a U.S. VAT. Many of these suggestions are based on chapter 1, and the discussion of overlapping parts will be brief.

Special Provisions

The use of special provisions, other than those necessary to preserve economic neutrality or prevent distortion of the VAT base through tax avoidance, should be minimized. Special provisions exact a heavy price by increasing the costs of compliance and administration, creating opportunities for the wary and traps for the unwary, and generally complicating the VAT. Several of these special provisions are discussed subsequently.

Rates

There should generally be only one rate (in addition to the zero rate). This standard rate should not be so high as to encourage excessive tax avoidance. However, a compelling case for multiple rates can be made to establish a low rate on an activity in lieu of exempting the activity (see chapter 4).

Zero Rating and Exemption

These should be used sparingly. Zero rating and exemption may be justifiable to minimize the impact of the VAT on lower-income groups or to deal with situations (such as
insurance\textsuperscript{118} and banking\textsuperscript{119}) in which the VAT would arguably be difficult to apply.\textsuperscript{120} Other situations, in which exempt status should be considered, exist when the activity has both business and non-business (exempt) customers and its purchase VAT is not significant in relation to its total sales (for example, postal services and insurance) or when the activity involves a large number of small suppliers and the purchase VAT of each is generally not significant.\textsuperscript{121}

**Credits**

The credit for a purchase VAT of a profit-seeking activity should generally be granted currently. Deferral of granting of the credit should be imposed largely to prevent tax avoidance or evasion. Other special credit treatments should be used sparingly (such as denying the credit for purchase VAT on selected purchases or granting a substituted credit or an additional credit).

**Tax Periods**

The tax period should be short enough so that the government receives its revenues currently and taxpayers do not need to wait an unnecessarily long time for refunds.\textsuperscript{122} It is relatively easy for each taxpayer to know his or her position currently because the credit method VAT is not based on profits but on tax imposed on sales and purchases. A tax period of three months should generally be imposed, with a one-month period required for taxable persons with poor compliance records and for larger businesses and available for others on an elective basis. However, the shorter the tax periods offered, the greater the likelihood of increased administrative and compliance costs.

For businesses filing for periods of three months or less, there need not be estimated taxes as under the federal income tax. In this connection, use of a short period will generally be more efficient than use of a one-year period with provisions for payment of estimated taxes. For the smallest businesses, however, a one-year period could be available, perhaps with estimated VAT prepayments.\textsuperscript{123}

The staggering of tax periods, and thus the staggering of the receipt and processing of returns, could ensure a smooth flow of work for the administrative agency and thereby reduce administrative costs.\textsuperscript{124}

**Timing**

Timing results under the VAT should generally be correlated with timing results under the income tax; that is, the time for reporting a sale or a purchase under the VAT should be the same as the time for reporting the comparable income or expense under the federal income tax, and vice versa.\textsuperscript{125}

Special rules may have to be fashioned that limit use of the installment method for reporting sales so that the sellers' timing for reporting the sales VAT is the same as the buyers' timing for claiming credits for the purchase VAT. Moreover, special rules may have to be fashioned that limit an accrual method purchaser's claiming of credit for VAT on a purchase from a related cash method seller.\textsuperscript{126}

If it is to be a goal that the federal income tax and the VAT follow similar timing rules, one important timing issue involves the role of the invoice in determining the timing of a sale and purchase under these taxes. The invoice has historically had an important and even central
timing role in a credit method VAT. It is generally agreed, however, that a credit method VAT need not give central importance to invoices and could function based on rules comparable to the income tax rules. Correlation of the federal income tax and VAT timing rules would probably save substantial administrative and compliance costs. Because federal income tax timing rules are already in place and are generally understood by taxpayers and their advisers, these rules should generally govern for VAT purposes.

Records

A related issue is the role of the invoice as part of a taxpayer's required records. Under credit method VATs, taxpayers have been required to acquire and preserve invoices as the basis for a purchase VAT credit and to issue invoices in sales to businesses and when requested in retail sales. The rationale for this emphasis on invoices is that they leave an ideal audit trail. The issuance of an invoice is also a clear indication that a sale and a purchase have occurred for timing purposes. Because invoices are issued in almost all commercial transactions, such a record-keeping requirement need not be unduly burdensome if the information required is reasonable. The principal burden imposed by placing central emphasis on invoices involves the preservation of invoices and use of the invoices on audit. However, a credit method VAT can function based on each taxpayer's accounting books and records under rules similar to those under the federal income tax. Such a system probably would not impose disproportionate administrative costs and could result in substantial savings in compliance costs.

To the extent that invoices are required to be issued and kept, it is desirable that information required be limited and not be overly broad.

Definitions

Efficiency will also be promoted when VAT definitions are clear and workable. These definitions should be based on commonly held concepts and distinctions when possible. VAT definitions should also be based on concepts that have professional understanding, such as concepts developed in the federal income tax, in accounting under generally accepted accounting principles, and in the customs law. For example, if it is necessary to distinguish between a repair and a capital expenditure, between personalty and realty, between profit seeking and non-profit seeking, or between an employee and an independent contractor, the considerable body of law under the federal income tax could be drawn upon.

Registration

Under one view, to promote the efficiency of a VAT, persons below a minimum threshold of gross receipts (for example, $50,000 or $100,000) should not be required or permitted to register. The argument against their registration is that compliance costs of persons with low gross receipts will be relatively high for the amount of revenue collected, as will administrative costs. However, if books and records required for the VAT will be the same as for federal income tax, these additional costs might not be as large as first appears.

Other considerations, both tax and nontax, favor a low threshold for required registration. For example, if a person is neither required nor permitted to register, that person will have an exemptlike status that is VAT-advantageous to retail business and VAT-disadvantageous to others. Competition will potentially be distorted. Further, the exemptlike status encourages VAT avoidance by the unregistered person as well as by that person's taxable customers. There
will also be additional administrative and compliance costs as a person moves in or out of registered status, unless the threshold for required registration is relatively low.\textsuperscript{134}

In addition, the existence of a threshold minimum for required registration is likely to be a trap for nonregistered persons who unwittingly exceed the threshold and are thus held responsible for uncollected VAT on sales.

Moreover, the fact that a person is not registered because of not meeting a threshold may be perceived by potential customers as an indication that his or her activities are only marginally successful, and such a person will be concerned about this perception. Lawyers, engineers, accountants, and other professionals may be especially desirous of registering.

The foregoing considerations weigh in favor of broad required registration, perhaps with an exemption for persons with only a nominal amount of annual gross receipts (for example, $2,500). Regardless of the threshold level for required registration, voluntary registration should be permitted.\textsuperscript{135}

If the required registration threshold is low (for example, $2,500), consideration should be given to sharing of VAT revenues with low-volume traders (for example, 20 percent of the amount otherwise remitted), with the sharing percentage dropping as gross receipts increase.\textsuperscript{136} On the other hand, if the required registration threshold is high (for example, $100,000 in annual gross receipts), consideration should be given to imposing a charge for voluntary registration.

Group registration should be permitted both in the parent-subsidiary corporation relationship and in the brother-sister corporation relationship. Further, if the required threshold for registration is set relatively high (for example, $100,000 in annual gross receipts), activities of related persons not filing as a group should be aggregated in determining whether the threshold has been met.

\section*{Administrative Agency}

The IRS is clearly the administrative agency that should be given primary responsibility for administration of a federal VAT,\textsuperscript{137} but it must be given adequate resources. The IRS already deals with most persons subject to VAT registration through the federal income tax and has the necessary experience with audits and record keeping. Selection of the IRS would enable the government to centralize computer capability in one system for both the VAT and the federal income tax. Moreover, selection of the IRS may work for common timing rules and definitions for the federal income tax and the VAT.

However, other agencies could be given responsibility for administration of the VAT in limited areas. For example, U.S. Customs could administer the VAT on the import and export of goods.
Special provisions will undoubtedly be introduced into a VAT to deal with theoretically difficult activities; to promote social, economic, or political objectives; or to deal with tax avoidance. This chapter evaluates selected special provisions, based largely on the criteria of efficiency and of effective avoidance prevention.

**Difficult Coverage: Exemption or Low Rates**

Exemption is one alternative for dealing with a business activity presenting difficult coverage problems (for example, banking or insurance). However, exemption is particularly undesirable in comparison with low or zero rating. Although both approaches involve no or low tax charged on sales, only exemption denies the input tax credit. For that reason, exemption spawns substantial tax avoidance planning and the complexity resulting from administrative and legislative responses thereto. The need for tax planning, and in turn its complexity, create a situation in which the sophisticated are rewarded and the unwary may be penalized. Moreover, to the extent that a nonretail business is exempt, a consumers tax falls on such a business. Finally, if the VAT denies purchase VAT credits on certain expenditures (such as automobiles and entertainment), exemption destroys the effect of such limited credit denial as to the exempt activity.

In contrast, low or zero rates for an activity do not spawn substantial tax avoidance planning and could be used as an alternative to exemption. The VAT rate could be set at a level that would collect approximately the same revenue as exemption, but without the distortions following exemption. For example, if exemption were being considered for domestic life insurance, the revenue to be collected from life insurance under the exemption approach could be estimated (that is, the noncreditable purchase VAT of life insurance companies). In place of exemption, a low VAT rate could be set on premiums on domestic life insurance risks which, after any purchase VAT credit for business, would approximate the revenue to be collected if the coverage of such risks were exempted.

**A Favored Activity or Product: Exemption, Zero or Low Rate, or Imputed Credit**

Under a VAT, the favoring of an activity or product might be sought to lessen the burden of the tax on low-income persons. In such a case, zero (or low) rates for the activity or product are clearly more efficient than exemption for the reasons noted previously.

The favoring of an activity might also be sought to encourage the activity or expand or increase its investment. In such a case, low or zero rates for the activity are a possibility.
However, an additional imputed credit may be preferable. The additional imputed credit would be more likely to be retained and used within the activity than would the benefits from a low or zero rate, at least for the short term. Further, the additional imputed credit would be easier to change by legislation than a low or zero rate because the former is more likely to be perceived as a benefit to the activity than as a subsidy to the consumer. Moreover, because the additional imputed credit acts on the activity and not the consumer, it would be relatively simple to vary the terms of the credit (for example, to phase it out after expenditures reach a specified level or to base it on increase in expenditures). However, the relative efficiency of the two approaches is not entirely clear in that, depending on the facts, it might be easier to identify a class of sales (on which a low or zero rate is imposed) than to identify a class of expenditures (on which an additional imputed credit is based), or vice versa.

A Disfavored Activity or Product: Denied Credits

An activity or product might be disfavored under the VAT for various reasons, and differing VAT techniques could be applied. In the following discussion we will deal with a business property or activity in which there is a likelihood of substantial personal use or satisfaction. When the mixed use (that is, partly business use and partly exempt or personal use) cannot easily be separated between business and exempt or personal, consideration should be given to denying VAT credit on purchases from that activity or of that product. The credit denial approach for such mixed use property is more compelling when it counterbalances favorable income tax treatment.

Under the credit denial approach, only the purchaser for resale is permitted a credit. Therefore, in the case of automobiles, the business purchasing an automobile for its own use or for lease would be denied a credit for purchase VAT. The credit denial approach has worked relatively efficiently in the United Kingdom in the limited areas applied: automobiles and entertainment. When it is relatively easy to separate business from personal use with mixed use property, an allocation should generally be made and the credit granted or recaptured under the rules described hereinafter. Such an allocation is particularly desirable if the mixed use property has a significant cost.

Changed Use: Recaptured or Additional Credit

To deal with the changed use of capital assets, rules will have to be fashioned, either upon enactment of the VAT or at a later date when problems become insufferable. These rules will be among the more complicated for the VAT. The potential complexity of these rules may in turn lead to efforts to restrict their applicability.

Initial Exempt or Personal Use

The change of use could be from exempt or personal use to taxable (business or investment) use, as, for example, in the conversion by a domestic insurance company of an office building from exempt use to taxable rental use. Failure to grant a current or deferred credit upon such conversion of property in these circumstances would discriminate against such property, assuming that there was previously noncreditable purchase VAT. This discrimination, among other things, would discourage persons from full ownership of property if initial exempt or personal use might change. A person would therefore be encouraged to acquire use of property by lease instead of purchase or by lease with an option to purchase. The transaction
might even be structured so that a related party purchases the property for lease to the intended user.

Several techniques could be used if a grant of a current or deferred credit on conversion from exempt or personal use to taxable use is desired. The following example illustrates the techniques:

An exempt insurance company acquired its headquarters building for $10 million and paid $1.5 million (at 15 percent) of noncreditable purchase VAT. After ten years of use out of an estimated useful life of forty years, the company changed the use of the building from exempt to rental use. The building was worth $8 million net of purchase VAT at the time of the conversion.

The amount of the credit could be determined upon conversion under one of the following techniques:

- **Fair-market-value technique.** The credit could be based on the lesser of the amount of the original purchase VAT ($1.5 million in the preceding example)\(^{147}\) or the amount of the purchase VAT that would be charged on the current value of the property ($1.2 million) (that is, 15 percent \(\times\) $8 million).

- **Earning-out technique.** The credit could be determined by assuming that the purchase VAT had been amortized or earned out over a period beginning with the original acquisition of the property. Under this technique the purchase VAT relating to the prior exempt or personal use would be denied as a credit and only the remainder of the purchase VAT would be available as a current credit. Amortization, or earning out, could be under a straight-line or interest method. (Therefore, in the preceding example, $375,000 (25 percent) of the original purchase VAT ($1.5 million) relates to the prior exempt use, based on straight-line amortization, and only $1,125,000 in purchase VAT would qualify for a current credit.)\(^{148}\)

The earning-out technique is preferable over the fair-market-value technique because of the relative efficiency of the former. The fair-market-value technique requires a determination of market value in each conversion and thus will potentially give rise to conflicts between the government and taxpayers. The earning-out technique, in contrast, should generally give rise to relatively easily determinable numbers. Moreover, the useful life of each asset that is used in amortization of the credit and in determining the period over which a partial credit may be claimed could be based on the income tax class lives. (The earning-out technique is also preferable, because it generally works satisfactorily in the “initial taxable use” and “mixed use” contexts, discussed below). The credit determined upon conversion could be allowed currently or deferred over the remaining useful life of the property. Simplicity would generally dictate a current credit upon conversion, unless there were facts indicating exempt or personal use in the future.

Interest should not be payable by the government by reason of its holding the purchase VAT prior to conversion, because the credit is not owing by the government prior to conversion. However, if a current credit is not granted in whole or in part upon conversion, interest should be paid by the government on the deferred credit.\(^{149}\)

**Initial Taxable Use**

The change of use could also be from taxable use to exempt or personal use, as, for example, in the conversion by a domestic insurance company of an office building from taxable rental use to exempt use. Failure to recapture a credit upon conversion of property from taxable use to exempt or personal use would discriminate in favor of such converted property. It would encourage taxpayers to acquire property for an initial taxable use with the plan to convert and thereby avoid a noncreditable purchase VAT.
Assuming that a recapture of a credit on conversion from taxable use to exempt or personal use is desired, several techniques could be used. The following example will illustrate these techniques:

The same facts apply as in the prior example, except that the initial use was taxable and the use after conversion was exempt. Therefore, a $1.5 million credit was allowed based on the initial taxable use.

The amount of the credit to be recaptured upon conversion could be determined under one of the following techniques (which parallel those discussed in the section titled "Initial Exempt or Personal Use"):150

• *Fair-market-value technique.* The credit to be recaptured could be based on the lesser of the amount of the original purchase VAT ($1.5 million in the previous example) or the amount of the purchase VAT that would be charged on the current value of the building ($1.2 million in the previous example).151

• *Earning-out technique.* The recapture amount could be the original purchase VAT remaining after subtracting an amortized credit relating to taxable use. (Thus, in the foregoing example, $375,000 (25 percent of the original purchase VAT of $1.5 million) relates to the prior taxable use, assuming straight-line amortization, and only $1,125,000 in purchase VAT would be subject to recapture.)152

The earning-out technique is preferable. (See discussion in the section titled “Initial Exempt or Personal Use.”)

Interest should not be payable by the taxpayer by reason of the earlier refund of purchase VAT, assuming there was no design to convert the property from taxable use to exempt or personal use at the time of purchase. However, if recapture is deferred in whole or in part upon conversion, interest should be paid by the taxpayer on the deferred amount.

**Initial Mixed Use**

Property could also be acquired initially for mixed use (both taxable and exempt or personal), and the mix could shift from year to year. For example, a partially exempt insurance company acquires a $100,000 computer, with the estimated use being 20 percent taxable (international) and 80 percent exempt (domestic), but the mix will undoubtedly change from year to year.

The credit granted for the period of purchase could be based on estimated initial use. However, if anti-avoidance procedures are not established, taxpayers will be encouraged to be overly optimistic in their estimated taxable use.

Several techniques should be considered, assuming that an anti-avoidance procedure is appropriate for property with an initial mixed use. Each of these techniques assumes that the credit is earned over a specified period, and thus requires amortization of the credit. The following example illustrates these techniques:

An insurance company acquired real estate for $10 million and paid $1.5 million (at 15 percent) VAT on it. Estimated initial use is 40 percent taxable (for rental) and 60 percent exempt (for the company’s own use), which is accurate for the first year. In the second year, however, taxable use drops to 30 percent, and in the third year taxable use rises to 50 percent. The property has an estimated useful life of forty years.

The following anti-avoidance techniques should be considered for mixed use property:

1. *Earning out—deferred credit.* The purchase VAT could be amortized over the property’s useful life or some other period, and the amount creditable each year could be based
on the actual use of the property each period. Using this approach in the foregoing example, assuming straight-line amortization, the purchase VAT credit for the first year would be $15,000 ($40 \times 40\% \times $1,500,000), for the second year would be $11,250 ($40 \times 30\% \times $1,500,000), and for the third year would be $18,750 ($40 \times 50\% \times $1,500,000).

2. Earning out—initial credit subject to recapture. A second technique would be to grant a full credit, subject to recapture over a recapture period based on the actual use in each year. Thus, a credit of $1.5 million would be granted upon purchase of the property. The recapture would be $22,500 ($40 \times 60\% \times $1,500,000) in the first year, $26,250 ($40 \times 70\% \times $1,500,000) in the second year, and $18,750 ($40 \times 50\% \times $1,500,000) in the third year, assuming straight-line amortization.

3. Earning out—estimated initial use subject to adjustment. Under a third technique, a credit could be granted initially based on estimated use, with a recapture or additional credit if use changes in subsequent years. Using this approach in the foregoing example, assuming straight-line amortization, the purchase VAT for the first year would be $600,000 (40\% \times $1,500,000) and there would be no recapture at the end of the first year. For the second year there would be a recapture of $3,750 (($40 \times .40 \times $1,500,000) – ($40 \times .30 \times $1,500,000)), and for the third year there would be an additional credit of $3,750 (($40 \times .50 \times $1,500,000) – ($40 \times .40 \times $1,500,000)). Under this third technique, adjustments to the initial (unearned) credit would be appropriate for long-life property when the estimated use proves to be significantly incorrect (for example, by 10 percent or greater). There would thus be an adjustment relating to future years and not the current year. For example, if the future years' adjustments were to be made every five years based on a five-year average and if the first five-year average were 30 percent business use (that is, 10 percent less than the 40 percent estimated business use), there could be a recapture of part of the credit granted for the remaining thirty-five years ($40 \times 10\% \times $1,500,000 = $131,250, assuming straight-line amortization). The current years' adjustments for the next five years or longer would then be based on an estimated 30 percent business use and not 40 percent.

Regardless of which of the foregoing techniques is chosen, any recapture or additional credit (whether for current years or five years) should be accompanied by a payment of interest. That is, interest should be payable by the government on the granting of an additional credit (numbers 1 and 3 above) and by the taxpayer upon recapture of the credit (numbers 2 and 3). The payment of such interest is not only equitable, but it is likely to discourage avoidance techniques and excessive claims by the government and by taxpayers.

Assuming that adequate interest is payable on any recaptured or additional credit, the three techniques are seemingly equivalent. However, a business might prefer an initial credit subject to recapture if the business assumed that it could earn a greater rate of return on alternative investments than the interest rate provided. In contrast, the government might prefer a deferred credit, largely because its position would not be jeopardized by the fortunes of the business. If any purchase credit were granted initially and were subject to recapture, the government might insist that its position be secured by a lien on the capital asset involved.

The estimated initial use technique perhaps would be generally satisfactory to both government and taxpayers, provided that the government did not receive a lien on the purchased capital asset and that the credit for future years (and not just the credit earned each year) could be subject to periodic adjustment for long-life assets in appropriate circumstances.

Nevertheless, if the rules for leasing and deferred purchases are not properly drawn, the foregoing techniques for mixed use property may discriminate in favor of leasing, deferred purchase of assets over cash purchase of assets, or both.
Leases and Deferred Payment Sales: Accelerated Remittance and Deferred Credits

Special rules should be considered for purchases of property to be leased and for deferred payment sales. Economic distortions and avoidance opportunities will be created in favor of leasing or deferred payment sales in many situations without these special rules.

Deferred User Credit—Mixed Use Property

When a user purchases a mixed use property (property to be used partly for business and partly for personal or exempt purposes), the user may have to defer part or all of the credit for purchase VAT.\(^1\) In such a case the deferred VAT would become available to the user in each year of the earn-out period based on relative business use in each year. Nevertheless, deferral of the credit may be undesirable from the user's point of view, particularly if provision is not made for payment of interest on such deferred credit as it is earned.

Either a leasing (taxable) or deferred payment purchase may represent a more attractive alternative to the user than a cash purchase of property. Under a lease, the lessor could presumably offer the user terms that would be attractive when compared with the user's alternative of cash purchasing the asset and taking a deferred credit with no provision for interest on the credit as earned. This is so because the lessor who purchases property for taxable lease would ordinarily take a credit for purchase VAT when paid or incurred, and would not have to defer the credit. To decrease or remove the economic incentive for entering into a lease over a cash purchase, the VAT could require the lessor to remit sales VAT on the maximum lease rents at the time the lease is entered into.\(^1\) Alternatively, the VAT could defer the lessor's purchase VAT credit for mixed use property leases over the property's useful life, an approach that could cause compliance problems for the lessor. A third approach, and perhaps the fairest, is for the government to pay interest for its use of a deferred credit when and as allowed, thereby making the cash purchase option more attractive.\(^1\)

Similar comments can be made about deferred payment purchases by the user. If the seller in a deferred payment sale is required to remit sales VAT only as payments are received, the user could have the benefit of a payment deferral that closely matches his deferred credit allowance. However, the VAT could probably make the deferred payment purchase less attractive economically, for example, by not permitting the seller's deferred remittance, thereby imposing an additional cost on the seller (presumably to be shifted in whole or in part to the buyer). Another alternative would be to decrease the user's cost by having the government pay interest on a deferred credit when and as allowed, as compensation for use of the user's money.

(The foregoing comments have assumed that the user and the lessor/deferred payment seller are unrelated. If the parties are related, special anti-avoidance rules should treat the user and the lessor or seller as one person.)\(^1\)

Denied User Credit

A federal VAT may deny the user of an asset a credit for purchase VAT (1) for purchase of certain assets for business use, such as an automobile,\(^1\) (2) to the extent the asset is used for exempt (or nontaxable) purposes,\(^1\) and (3) to the extent the asset is used for personal purposes.\(^1\)

The leasing of an asset by the user could be favored over its cash purchase, assuming that the lessor of such assets to the user would be granted a full credit for purchase VAT at the time the lessor acquired the asset. Thus, in those situations in which the user would be denied a credit for purchase VAT, the lease defers that denial (until rentals are paid), while the lessor gets a current credit for purchase VAT paid or incurred.
The following alternative approaches are appropriate to discourage leasing from being used as a technique for a denied credit deferral when the *business user* would be denied a credit on purchase of an asset because of the nature of the asset, such as an automobile: (1) Deny the lessor's credit upon purchase of the asset for lease (however, the lessor would charge the user sales VAT upon the rentals, which sales VAT would be creditable to the user upon business use), or (2) defer the lessor's credit for purchase VAT. The first approach (credit denial to lessor) is used in the United Kingdom and is relatively simple in operation in comparison with the second approach.

The following approaches are appropriate to discourage leasing from being used as a denied credit deferral technique when the credit would be denied in whole or in part because of the *exempt or personal* use of the asset by the user and when the lease is long-term (1) Require the lessor to remit sales VAT at the time of the lease on the future rentals, or (2) defer the lessor's purchase VAT credit for the asset over the term of the lease. The first approach would arguably be more effective than the second because the lessor's purchase VAT (second approach) might be significantly smaller than the total sales VAT on the lease (first approach).

The *deferred payment purchase* of an asset by the user could be favored over its cash purchase, assuming that the seller remits sales VAT only upon receipt of the payments. In such a case economic decisions would be distorted to favor the deferred payment purchase.

At least one approach is appropriate to prevent deferred payment purchases from being used as a denied credit deferral technique: to require that the seller currently remit the full sales VAT on the deferred payment sales. If such a sweeping rule is unacceptable, it could be limited to sales of credit-denied assets and to significant sales of other assets.

(The foregoing comments have assumed that the user and the lessor or deferred payment seller are unrelated. If the parties are related, special anti-avoidance rules should treat the user and the lessor or seller as one person.)

**Used Property: Imputed Credit, Margin Scheme, and Revived Credit**

Used property will generally be of two types: used property inside the VAT "ring" and used property outside. Used property inside the VAT ring has not previously been subjected to a denied credit for purchase VAT and generally includes business property. Used property outside the VAT ring has previously been subjected to a denied credit for purchase VAT and generally includes property used for exempt or personal purposes, as well as business property on which a credit for purchase VAT has been denied. Mixed use property could be both inside the VAT ring and outside. Further, property giving rise to a deferred credit is in a sense both inside the VAT ring and outside.

Used property inside the ring gives rise to no unusual problems when it is sold, whether the purchaser is to use the property for a business purpose (inside the VAT ring) or an exempt or personal purpose (outside the VAT ring). The seller would charge appropriate VAT on the sale, and the buyer would claim or not claim a purchase VAT credit, depending on the buyer's intended use and the nature of the property.

Used property outside the VAT ring raises several problems. First of all, if used property outside the VAT ring is brought back into the ring, should it be subject to the special rules that recognize that the property previously had borne VAT (hereinafter, the "out-in situations")? Failure to give such recognition in the out-in situations will discriminate against such property, thereby distorting economic decisions and encouraging VAT-avoidance schemes. This potential discrimination will exist whether used property is acquired by a business for its own use or for resale. Double taxation could even arise if the property again leaves the VAT ring.

Furthermore, if used property outside the VAT ring is sold for an exempt or personal use (that is, the property remains outside the VAT ring), should the sale be subject to the VAT
Subjecting the later sale of used property to VAT in the out-out situations will create significant double-taxation problems. Further, extending the VAT to unregistered individuals and organizations will create significant administrative problems in collecting the tax and even in other areas. Because of these problems, it is assumed in the following discussion that the VAT will not generally apply to sales of used property in the out-out situations. Any VAT coverage would be in unusual cases (for example, large sales of investment-type tangible assets such as stamp and coin collections, historical papers, works of art, and antique and historical objects, as well as real estate). (A good case could be made, based on administrative consideration, for limiting VAT coverage of the out-out situations to transactions involving the participation of attorneys or brokers or involving a paper trail, as is the case with real estate.) In place of partial VAT coverage of investment-type tangible assets in the out-out situations, the income tax could be modified to increase the income tax on dispositions of these assets in out-out situations, thereby perhaps imposing an income tax equivalent to the VAT.

The principal techniques for avoiding or minimizing discrimination against used property are fivefold:

**Zero Rating.** Zero rating of used property would avoid double taxation but would also eliminate taxation of any value added after the prior sale outside the VAT ring (including value added by business). Zero rating is not a satisfactory solution because this value added could be significant.

**Exemption.** Exemption of sales of used property is not ordinarily a satisfactory solution for the out-in situations because it requires that business be exempted or partially exempted and thus generally gives rise to the serious attendant problems discussed previously.

Exemption of sales of used property, however, would ordinarily be a satisfactory solution for the out-out situations. Nevertheless, exemption would not be a satisfactory solution in the case of investment-type tangible assets because considerable value could be added by collecting and holding the property. Exemption of investment-type tangible assets assumes that they will bear an equivalent tax in another context.

**Imputed Credit.** A third technique for avoiding or minimizing discrimination against used property in out-in situations would treat part of the purchase price as being VAT when the property is brought back into the VAT ring. The first business purchasing for resale or use (that is, the business bringing the property back into the VAT ring) would be granted an imputed purchase VAT credit, based on the purchase price. The following formula is used to determine the imputed purchase VAT:

\[
Purchas e \text{ Price} \times \frac{\text{VAT Rate}}{100\% + \text{VAT Rate}}
\]

For example, if the VAT rate were 15 percent and the purchase price were $115, then $15 or $15/115 of that price would be the imputed purchase VAT. This first business would take the imputed credit in the period of purchase, unless the credit were deferred or denied because of the use to which it puts the property.

Relevant characteristics of the imputed credit technique in out-in situations are as follows:

- It permits (when appropriate) a credit for purchase VAT for the period of the purchase and thus does not require that the credit on goods held for sale be deferred or that the credit be matched with goods sold.
- It provides a credit (when appropriate) for a business that acquires used property for use as well as for sale.
• It is not suitable to apply to the acquisition of mixed use property partially within the VAT ring.
• It needs no special adjustments for inflation or for VAT rate changes because it is based on the current purchase price and the current rate.

The imputed credit technique could even be modified for use in out-out situations. In those unusual out-out situations to be subject to the VAT, the seller of covered used property outside of the VAT ring could be granted an imputed credit for purchase VAT at the time of sale, based on the seller's income tax basis, and would charge VAT on his or her sale.

Relevant characteristics of the imputed credit in out-out situations are as follows:

• It requires no special proof of payment of VAT and refers to an amount that is generally familiar to individuals, namely, income tax basis.
• It does not subject to the VAT value added before the enactment of the VAT.
• It needs no special adjustments for VAT rate changes because it would be based on the current VAT rate.
• It needs no special adjustments for inherited property or gifted property because income tax cost takes into account adjustments to cost at the time of death (fair market value) or of gift (potential increase for part of gift tax paid).

Margin Scheme. A fourth technique for avoiding or mitigating discrimination against used property in out-in situations would compute the VAT to be remitted on resale of the property by a business under a “margin scheme.” Under this scheme the VAT would be imposed only on the difference between the sales price and the purchase price of each used asset bought and sold. In the United Kingdom, which uses the scheme for nine classes of goods, the VAT to be remitted is determined “tax inclusive” on this difference. The formula for determining such a VAT is as follows:

\[
\frac{(Sale\ Price - Purchase\ Price) \times \text{VAT Rate}}{100\% + \text{VAT Rate}}
\]

Thus, if the VAT rate is 15 percent, the sales price of an asset by a business is $330, and its purchase price was $100, then its margin would be $230 ($330 - $100) and its VAT to be remitted would be $30 ($230 \times \frac{15}{115}). If the second business resold the property for $446 at a time when the VAT rate is 16 percent, its margin would be $116 ($446 - $330) and its VAT to be remitted would be $16 ($116 \times \frac{16}{116}).

Relevant characteristics of the margin scheme in out-in situations are as follows:

• It permits no benefit to business from the VAT implicit in the price of used property purchased for resale until the property is sold, and it requires that the eventual benefit be matched with the sale of the property.
• It gives no benefit to a business that acquires used property for use and not for resale.
• Moreover, it is not suitable to apply the acquisition of mixed use property partially within the VAT ring because it assumes that the seller previously received no credit for his purchase VAT.
• It needs no special adjustments for inflation occurring when the property was used outside the VAT ring or for VAT rate changes.

The reason(s) for the U.K. preference for the margin scheme over the imputed credit are not entirely clear in view of the apparent relative advantages of the imputed credit (concerning the
first two items above). Apparently, there was concern under the invoice-conscious U.K. system that the imputed credit technique would encourage fraud.\textsuperscript{181} This is because it grants a current imputed credit without an invoice on the purchase of goods and because it does not match this credit with related later sales. An income tax system, however, does not need special invoice rules to deal with the purchase and sale of used assets.

The margin scheme could even be adapted for use in the \textit{out-out} situations. In those unusual out-out situations to be subject to the VAT, the seller of covered used property outside the VAT ring could be required to determine VAT remittance under a margin scheme that refers to income tax basis as the purchase price under the tax-inclusive formula.

Relevant characteristics of the margin scheme in out-out situations are as follows:

- It generally avoids VAT on value added before the enactment of a VAT.
- It is not suitable to apply to the acquisition and sale of mixed use goods.
- It is similar to an income tax, since it is based on the difference between the sales price and the purchase price.

Because of the similarity of the margin scheme to an income tax, \textit{all} out-out situations (including sales of investment-type assets) should be subjected to increased tax under the regular income tax instead of only investment-type assets being subjected to VAT under the margin scheme.\textsuperscript{182}

\textit{Revived Credit.} A fifth technique for avoiding or mitigating discrimination against used property would subject covered used property to VAT on every subsequent resale, even if not by a business.\textsuperscript{183} However, a seller would be entitled to claim any previously unallowed credit (whether denied or deferred) in determining the amount to be remitted (but not in giving rise to a refund). As an example, assume that residential real estate is subject to the VAT and that an individual previously purchased a residence for his personal use for $100,000, the individual paid $10,000 VAT (at 10 percent), and the purchase VAT was denied as a credit. If the residence were later sold by this person for $120,000 at a time when the VAT rate is 15 percent, he would collect $18,000 sales VAT but would remit only $8,000 ($18,000 − $10,000). On the other hand, if the residence were sold by this person for $60,000 (and not $120,000), he would collect $9,000 VAT on the sale but would have to remit nothing and would not be able to get a refund on the remaining $1,000 of the prior denied credit.

Relevant characteristics of the revived credit technique are as follows:

- It requires a determination of prior purchase VAT that had not been granted as a credit.
- It needs special adjustments for inflation and for any VAT rate change (indexing for inflation and converting VAT under old rates to VAT under new rates).
- It will tax pre-VAT enactment value added.
- It permits a credit to a business for purchase VAT for the period of the purchase.
- It provides a credit for a business that acquires used property for use (as well as for sale).

The revived credit is generally well suited for mixed use property,\textsuperscript{184} because it permits the business to recover any denied or deferred credits (except to the extent amortized). However, it is not suggested for other out-in business situations because it needs special adjustments for inflation\textsuperscript{185} and for VAT rate changes and because it taxes pre-VAT enactment value added.

The revived credit is also not suitable for either out-in or out-out situations involving unregistered persons. First, unregistered persons are likely to encounter difficulty in making necessary proof (for example, proof of the amount of denied purchase VAT and proof that the seller to the unregistered person remitted the purchase VAT when the unregistered person
bought the property). Second, when unregistered persons are subject to the VAT only on larger sales (as probably is necessary), an inequitable situation will potentially be created when the unregistered person's purchase price did not exceed the threshold amount but his sales price does. In such a case the unregistered person would have to charge sales VAT but would have no purchase VAT for a credit (even though the used property might have borne VAT when placed in service as new). 186

Conclusions

For the reasons stated previously, it is recommended that the following kinds of used property situations be covered with the following techniques: 187

- Out-in situations involving mixed use property—revived credit
- Other out-in situations—imputed credit
- Out-out situations involving covered investment-type tangible property—imputed credit
- Other out-out situations—exemption

Unused VAT Credits Under the Federal Income Tax

The denial, recapture, or deferral of the VAT credit for purchase VAT ("unused VAT credits") 188 will present problems under the federal income tax. Should unused VAT credits give rise to federal income tax benefits, either as expenses or capitalized costs? If so, subsequent VAT allowance of unused VAT credits will give rise to potential taxable income under the tax benefit rule. That is, there would be income under the federal income tax, but only to the extent that the prior unused VAT credit had previously been deducted and the deduction offset income.

An approach to the federal income tax problem that is generally equitable, consistent with the federal income tax rules, and not unduly complicated is described below. This approach assumes that the VAT credit will be denied, recaptured, deferred, or granted unaffected by the federal income tax results.

Denied or Recaptured VAT Credits

Purchase VAT that is denied as a credit and a prior credit that is recaptured would be deducted, capitalized, or disallowed as deductible or capitalizable costs under the usual federal income tax principles. 189 The denial or recapture of the VAT credit, however, will generally be related to a tangible fixed asset and thus will generally be capitalized, subject to possible depreciation. If the previously denied or recaptured VAT credit is subsequently allowed or revived as a VAT credit, 190 it would potentially give rise to taxable income under the tax benefit rule of the federal income tax.

Deferred Credits

Deferred credits should not be allowed presently as a federal income tax deduction or a capitalized cost because they will potentially be allowed by the VAT. 191 If and when such a deferred credit is allowed by the VAT, it will not give rise to income taxation under the tax benefit rule of the federal income tax. On the other hand, if a deferred credit is denied by the VAT, it should be treated as a denied credit at that time and deducted, capitalized, or disallowed as a deduction or capitalized cost, as appropriate under the federal income tax. 192


**Used Property and the Tax Benefit Rule**

The following techniques suggested for avoiding VAT discrimination against used property (discussed in the previous section) need not avoid the tax benefit rule:

- The revived credit suggested for out-in used property situations involving mixed use property represents the VAT allowance of a previously unused VAT credit and thus should be treated as such under the federal income tax.
- The imputed credit suggested for other out-in situations does not represent VAT allowance of an unused credit to the person to whom it is granted (the first business buyer). Further, although the seller was previously granted a basis increase in the sold property for the denied credit, presumably this basis increase will be offset by a higher price the buyer is willing to pay (because the buyer gets an imputed credit).
- The imputed credit suggested for out-out used property situations involving certain investment-type tangible property is granted to the seller who previously capitalized a denied credit, and it should therefore be treated either as a reduction of his income tax basis or an amount realized on his sale.
- Exemption suggested for other out-out situations is not equivalent to granting the buyer or seller a credit and thus requires no special income tax treatment.
Chapter 5

FAIRNESS

A VAT should be structured so that it not only operates fairly but is also perceived as operating fairly by ordinary citizens and by managers and owners of businesses. As accountants, we are especially concerned that the VAT is perceived as fair because we recognize that perceptions of unfairness will erode support for a VAT and will encourage avoidance and evasion schemes. In furtherance of fairness in operation and in perception, the following matters are among those that should be considered.

Vertical Equity

A broad-based, credit method VAT is regressive in the sense that as spending power, income, or wealth decreases among families and classes, the relative burden of the tax increases to the extent that the VAT burden is shifted forward to consumers. This regressivity is a subject of concern to both proponents and opponents of the VAT. Alternative solutions to the regressivity problem include the following:

- Noncoverage of necessities. Necessities such as housing, food (but not restaurant food), utilities, bus and rail intracity transportation, and medical care would be zero rated or low rated.
- Increased transfer payments. Government-provided transfer payments would be increased to the extent that they are not automatically adjusted to compensate for the cost-of-living increase caused by the VAT.
- Reimbursement for the VAT. The increased burden on the poor from the VAT would be reduced by reimbursing those at lower income levels, either through an income tax credit or through a refund independent of the income tax.

In the public’s view, of these suggested solutions the zero rating of necessities and the reimbursement of the VAT are the most likely to be connected with the VAT and thus improve the VAT’s image. Zero rating of necessities is likely to create the most favorable impression of the VAT, although it probably is the costliest solution from the government’s viewpoint. The solution favored by the U.K. VAT is to zero rate certain necessities.

Owner-Occupied Housing

A broad-based credit method VAT could be resented by the middle class because of its impact on owner-occupied housing. Assuming that the VAT rate is relatively high (a realistic assumption in view of the history of the VAT in Europe) and that necessities are standard rated, a broad-based VAT shifted forward to the consumer will add a significant cost to
housing. In particular, middle-class ownership of housing is likely to suffer. As a consequence, a broad-based VAT is likely to be an unpopular tax with the middle class. It thus seems especially desirable that housing be zero rated or low rated under the VAT if necessities are not zero or low rated.

**Losers and Winners**

The credit method VAT is designed to be collected by the seller from the buyer and remitted by the seller (net of purchase VAT). Two potential inequities arise out of this characteristic. If the seller fails to collect this tax or collects tax at too low a rate through mistake of fact or law, whether culpable or innocent, the seller nevertheless must make the proper remittance and may have no practical recourse against customers. A long delay in correcting an erroneous practice could be extremely difficult financially on a business. Fairness toward business and desirable perceptions of fairness by owners and managers of business can only be promoted through clear rules and "bright lines," effective dissemination of these rules among business, a properly staffed revenue agency, and prompt resolution of disputes and policy questions. Failure to take such steps will make the VAT unpopular with managers and owners of business.

On the other hand, if the seller by mistake collects excessive VAT from customers and gets a refund for excess VAT remitted, the seller who pockets the refund and does not pass it on to consumers apparently gets a windfall. In this connection, it might not be practical or possible to locate buyers and make a refund. Further, it is impractical to determine to what extent the seller bore the VAT and to what extent the buyers, the suppliers of the seller, or both bore the VAT. As a consequence, refunds should be made to sellers whether or not as a practical matter customers and suppliers will get any benefit from the refund. However, any problem will be minimized by taking the steps suggested previously for insufficient tax.
Appendix A

Value-Added Tax Rates in January 1989 (Europe)

<table>
<thead>
<tr>
<th>Country</th>
<th>Standard (%)</th>
<th>Lower (%)</th>
<th>Luxury (or Higher) (%)</th>
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</thead>
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<tr>
<td>Austria</td>
<td>20</td>
<td>10</td>
<td>32</td>
</tr>
<tr>
<td>Belgium</td>
<td>19</td>
<td>6 &amp; 17*</td>
<td>25†</td>
</tr>
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<td>Denmark</td>
<td>22</td>
<td>—*</td>
<td>—</td>
</tr>
<tr>
<td>France</td>
<td>18.6</td>
<td>5.5*</td>
<td>25†</td>
</tr>
<tr>
<td>West Germany</td>
<td>14</td>
<td>7</td>
<td>—</td>
</tr>
<tr>
<td>Greece</td>
<td>16</td>
<td>6*</td>
<td>36</td>
</tr>
<tr>
<td>Ireland</td>
<td>25</td>
<td>0*</td>
<td>—</td>
</tr>
<tr>
<td>Italy</td>
<td>19</td>
<td>4 &amp; 9*</td>
<td>38</td>
</tr>
<tr>
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<td>12</td>
<td>3 &amp; 6</td>
<td>—</td>
</tr>
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<td>18.5</td>
<td>6</td>
<td>—</td>
</tr>
<tr>
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<td>20</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
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<td>0 &amp; 8</td>
<td>30</td>
</tr>
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<td>12</td>
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<td>33</td>
</tr>
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<td>—</td>
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<td>15</td>
<td>0</td>
<td>—</td>
</tr>
</tbody>
</table>

Notes:
*Additional lower or zero rates applied to a limited group, or limited groups, of commodities.
†Additional tax on some commodities.

Under guidelines adopted by the Council of EEC finance ministers on December 18, 1989, all national VAT rates have to be set within two rates: the standard rate and the reduced rate. Further, the standard rate is to be no lower than 14 percent and no higher than 20 percent.


Source: For updated rates, Her Majesty's Customs and Excise.
## Appendix B

General Consumption Taxes and Value-Added Tax as a Percentage of Total Taxation

<table>
<thead>
<tr>
<th>Country</th>
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<th>1975 Consumption</th>
<th>1985 Consumption</th>
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<td>17.2</td>
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Note:
*The VAT is a form of general consumption tax and, therefore, included in the general consumption tax figure. In some instances, it is the only consumption-type tax.*

Appendix C

General Consumption Taxes and Value-Added Tax* as a Percentage of Gross Domestic Product

<table>
<thead>
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<th></th>
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<th></th>
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</tbody>
</table>

Note:
*The VAT is a form of general consumption tax and, therefore, included in the general consumption tax figure. In some instances, it is the only consumption-type tax.

Notes

1. See AICPA Statement of Tax Policy No. 2., Value-Added Tax (1975), 2; AICPA Tax Division, Alternatives to the Present Tax System for Increasing Saving and Investment (Washington: AICPA, 1985), 30. However, the AICPA Tax Division is presently reviewing its position on consumption taxes, including the credit method VAT. The American Bar Association and its Section of Taxation have formally recommended that a credit method VAT be employed over other methods.

2. Professor Bravenec studied the U.K. VAT during the period January through May 1988, interviewing approximately fifty VAT specialists from accounting firms, law firms, industry, and government (Her Majesty's Customs and Excise) (hereinafter “U.K. persons surveyed”). Observations on the operation of the U.K. VAT are based on these interviews. When a statement is made about the views of U.K. persons surveyed, it will usually give both the percentage of persons expressing an opinion (but not including those not expressing an opinion) and the percentage of all persons surveyed (including those not expressing an opinion) (for example, “U.K. persons surveyed (62 percent, 41 percent—note 2) agree that . . . ”). If a statement is based on conversations with U.K. persons surveyed (but not a formal survey), it is expressed as “many U.K. persons surveyed.”

References are made to various U.K. sources, which are abbreviated as follows:

C&E—Her Majesty's Customs and Excise
Commissioners—Commissioners of C&E
EEC—European Economic Community
FA—Finance Act
Reg.—Regulation
Sch.—Schedule (e.g., 4 Sch. = Fourth Schedule)
SI—Statutory Instrument

Complete U.K. statutory and administrative materials, as well as the EEC Council directives, may be found in J.F. Avery Jones, Encyclopedia of the Value Added Tax (London: Sweet & Maxwell, 1989). Limited reference will also be made to the New Zealand Goods and Services Tax Act 1985, as amended (hereinafter “New Zealand GSTA”).

3. November 1984 (hereinafter the "1984 Treasury Report"). Further, this study neither duplicates nor evaluates the major design work "Value Added Tax: A Model Statute and Commentary, A Report of the Committee on Value Added Tax of the American Bar Association Section of Taxation" (1989) (hereinafter the "ABA Tax Section VAT Committee Report").

4. Many U.K. persons surveyed (note 2) do not consider their VAT to be a neutral tax, and they do consider their VAT presently to rival their income tax in complexity. The consciousness of these U.K. persons surveyed that their VAT was not a neutral or simple tax was perhaps raised over the past decade with the 1979 increase in the U.K. standard VAT rate from 8 percent to 15 percent and with the government’s efforts to minimize avoidance of the tax. (The 1979 increase was accompanied by a move from a multiple-rate structure to a single-rate structure (not including the zero rate).) In this connection, Anthony Barber, the U.K. Chancellor of the Exchequer during the adoption of the U.K. VAT stated the objective of pre-adoption consultations as follows:

This process of consultation has been invaluable in planning the details of the tax with the object of ensuring that from the point of view of industry and commerce it will be at least as simple to operate as in any of the eight European countries which now have a V.A.T., and much simpler than in most of those countries. [833 H.C. Deb. 1368 (March 21, 1972).]
The discussions which the Customs and Excise will have will be based on published information. . . . If we are to have the simplest VAT in Europe, which I am determined we shall have, it is essential that the Customs and Excise, in its discussions with trade and industry, shall not be hamstrung in any way. [834 H.C. Deb. 207 (March 28, 1972).]

5. See, for example, Ken Sanden, “VAT: What, How, Where,” Tax Adviser (March 1973): 151–52; John Nolan, “Advantages of Value Added or Other Consumption Tax at the Federal Level,” National Tax Journal (1972): 433; Charles McLure, “Economic Effects of Taxing Value Added,” in Broad-Based Taxes: New Options and Sources, ed. Musgrave (1973), 173; Dan T. Smith, James Webber, and Carol Cerf, What You Should Know About the Value Added Tax (1973), 80–86; Dan T. Smith, “Value-Added Tax: The Case for,” Harvard Business Review (Nov.—Dec. 1970): 79–80. Care must be taken to meet proponents of the VAT on exactly those neutrality characteristics attributed to the VAT and those lack-of-neutrality characteristics attributed to the income tax. It should be noted that the introduction of the VAT could change the relative tax burden of (1) an industry, (2) the products of an industry, (3) a company within an industry, or (4) consumers and savers. Further, the VAT will probably have a different incidence from that of existing taxes. See Smith, Webber, and Cerf, What You Should Know About the Value Added Tax, 97–137.

6. The fully taxable person in U.K. terminology is referred to as the “tax collector,” while the ultimate consumer is referred to as the “taxpayer.” The U.K. terminology will not be used herein.

7. This form of VAT is referred to as the credit method because of the credit allowed for VAT paid on purchases. It can also be referred to as the indirect subtractive approach.

   An alternative subtractive approach first computes value added and then applies the tax rate: VAT Liability = Rate \times (Taxable Sales Less Taxed Purchases). This method could be called an accounts method, since it relies on net sales and net purchases taken from taxpayers’ books of account. It can also be referred to as the direct subtractive approach. The accounts method theoretically gives the same result, apart from timing differences, as an additive method that measures value added as the sum of profits and other payments to the factors of production not otherwise taxed, such as depreciation, wages, interest, and rents. This factors-of-production method is rarely used. See text accompanying at notes 74—79 below.

8. Sales VAT is generally not included in the tax base. However, VAT could be included in the tax base of retail sales. Value Added Tax: A Report by the National Economic Development Office (London: Her Majesty’s Stationery Office, 1971), (hereinafter ”NEDO Report”). The formula for determining the VAT collected on a tax-inclusive basis is as follows:

\[
\text{VAT Collected} = \frac{\text{VAT Rate}}{100% + \text{VAT Rate}} \times \text{Sales Price}
\]

Thus, if the sales price were $110 and the VAT rate were 10 percent, the VAT deemed collected would be $10 ((10%/110%) \times $110). The foregoing formula is referred to in the United Kingdom as the “VAT fraction.” Determination of the VAT under a VAT-inclusive approach (that is, under the VAT formula) will be appropriate in the margin scheme (see text accompanying note 179), the imputed credit (see text accompanying note 177), and certain retail sales. See C&E Notice 700 (Oct. 1987), paragraph 29 (pay phones); C&E Notice 727 (Oct. 1988) (retail schemes).

9. An immediate full credit for purchases of capital goods is not preordained. See notes 89–98 below and accompanying text.

10. With identical rates of taxation, assuming no substantial reduction of the base for tax, the credit method VAT will yield revenues comparable to those collected from a retail sales tax levied on both goods and services and levied only at the final stage of the distribution process.

11. The VAT described up to this point is known as a consumption form of the VAT. An income form of the VAT would grant a credit for inventory and capital goods based on their utilization.

12. There may be a rate threshold to be crossed before businesses and their tax advisers enter into a new dimension of tax planning and compliance and revenue officials similarly enter into a new dimension of prevention of tax avoidance. This threshold was apparently crossed in the United Kingdom in 1979, according to many U.K. persons surveyed, when the standard rate was
increased from 8 percent to 15 percent. From April 1, 1973, the date of introduction of the VAT, to the present, the U.K. rates have been—

<table>
<thead>
<tr>
<th>Date Range</th>
<th>Standard Rate</th>
<th>Higher Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Apr. 1, 1973–July 28, 1974</td>
<td>10%</td>
<td>—</td>
</tr>
<tr>
<td>July 29, 1974–Nov. 17, 1974</td>
<td>8</td>
<td>—</td>
</tr>
<tr>
<td>Nov. 18, 1974–Apr. 11, 1976</td>
<td>8</td>
<td>25%</td>
</tr>
<tr>
<td>Apr. 12, 1976–June 17, 1979</td>
<td>8</td>
<td>12.5</td>
</tr>
<tr>
<td>June 18, 1979–Present</td>
<td>15</td>
<td>—</td>
</tr>
</tbody>
</table>

(The higher rate for November 18, 1974 to April 11, 1976 was originally limited to petrol products but was expanded on May 1, 1975.) FA 1972 sec. 9(1); SI 1974/1224; FA 1975 secs. 1, 2; FA (No. 2) 1975 sec. 17; FA 1976 sec. 17; FA (No. 2) 1979 sec. 1. For the fiscal year ending March 31, 1989, the U.K. central government’s revenues from its VAT and car tax constituted 23.6 percent of its total revenues. For the same fiscal year, revenues from VAT, customs, and excise constituted 40.9 percent of total revenues. Her Majesty’s Customs and Excise, Report for the Year Ended 31 March 1989 (1989), (hereinafter “H.M. Customs and Excise 1989 Report”). The percentage of total tax revenue in the United Kingdom represented by its VAT has increased steadily following its introduction. See Organization for Economic Co-operation and Development, Revenue Statistics of OECD Member Countries, 1985–1986 (Paris: OECD), 149.

VAT rates throughout Europe are generally high by U.S. consumption tax standards, the standard rate ranging from 12 percent (Spain) to 25 percent (Ireland). The average standard rate for Europe (not including Turkey) is 18.18 percent. See appendix A above (p. 39).

The VAT raises substantial revenue for the European countries where it is employed, raising in 1985 from about 13 percent of total tax collections (Luxembourg) to about 21 percent of total tax collections (Austria and Ireland), in contrast to the 7.4 percent for general consumption taxes in the United States. As a percentage of gross domestic product in the European countries, it ranged in 1985 from 5 percent (Italy) to 9.9 percent (Denmark), in contrast to the 2.2 percent for general consumption taxes in the United States. See appendixes B and C above (pp. 41, 43).

13. The likely incidence of the VAT has been treated extensively in the literature and need not be considered here. For an excellent discussion of VAT incidence, see Clara Sullivan, The Tax on Value Added (New York: Columbia University Press 1965), 263–83.

14. As an alternative to a reduced rate, the tax base could be reduced, for example, by 40 percent. NEDO Report, 33. Such a reduction was adopted in the United Kingdom as part of a transition from exemption to standard rating of rental nondomestic real estate. 1989 Finance Bill, 4 Sch. paragraph 4(5). The tax base is reduced by one-half for one year under existing commercial leases, but there is a phased-out four-year relief for charities. See also, Her Majesty’s Customs and Excise, News Release No. 47/88, “Consultation Paper: VAT on Non-Domestic Construction” (June 21, 1988), Introductory Statement (d), in J.F. Avery Jones, Encyclopedia of the Value Added Tax, 5-884.


16. The United Kingdom makes extensive use of zero rating (note 20 below), whereas Denmark’s use of zero rating is minimal.

17. When there are multiple rates (including a zero rate), retailers may find it difficult to determine the tax liability because of uncertainty concerning the amount of sales at each rate. Retailers may thus require special schemes to determine sales under each rate. In the United Kingdom, for example, there are twelve possible retail schemes, one or more of which may be available to each retailer depending on the retailer’s situation. The U.K. retail schemes generally permit the retailer to determine timing of sales under the cash method, while not taking away the retailer’s ability to determine timing of purchases under the accrual method. As a result, the U.K. retailer can generally have the best of the cash and accrual methods. C&E Notice No. 727 (Oct. 1988).

18. For a discussion of the cash flow advantages and disadvantages of subjecting intermediate stages to the VAT, see the section titled “Cash Flow Effects of the VAT” (pp. 5–7).

19. If the retail level in an activity is characterized by avoidance of either the income tax or the VAT, some of the avoided tax could be recovered through the VAT at the intermediate level. For
example, if home improvements were low rated under the VAT but were characterized by income tax avoidance by contractors taking cash, the sales of easily identifiable building materials could be standard rated. The contractor would either report the supply on his VAT return to claim the credit, thereby making him or her vulnerable to income tax audit, or would forgo filing a VAT return, thereby decreasing the amount of avoided tax. (This approach might be difficult to explain to homeowners who make their own improvements.)

20. The United Kingdom zero rates fifteen activities or groups, the principal being food, sewerage services and water for nonbusiness customers, books, fuel and power for residential or charitable use, exports, and construction of buildings for residential or charitable purposes. VATA 1983 secs. 16(2)–(5), 48(6), 48(7) and 5 Sch.; FA 1984 sec. 13. (See note 146 below.) In contrast, New Zealand makes minimal use of zero rating, principally for exports. New Zealand GSTA sec. 11.

21. However, a zero rate could be imposed on an intermediate level if sellers at that level might have trouble in remitting VAT payable to the government. For example, if the government experiences difficulty in collecting VAT from building subcontractors but not contractors, supplies by subcontractors could be zero rated. The revenue loss from zero rating would be recovered at the next level, assuming that collection problems are not presented at this level.

22. Zero rating of sales to governmental units and to certain charities, together with exemption of these entities, was considered but not recommended as a method for their noncoverage in the 1984 Treasury Report, 69–72. The United Kingdom zero rates certain provisions of goods and services to charities or for charitable purposes. VATA 1983, 5 Sch. groups 1, 4, 7, 8, 10, 14, 16. The United Kingdom also zero rates certain provisions of goods and services for residential use. VATA 1983, 5 Sch. groups 7, 8. In addition, it zero rates the provision of sewerage services and water for nonbusiness customers. VATA 1983, 5 Sch. group 2.

23. A similar problem is presented by consumer discounts and by rebates (for example, rebates by supply cooperatives).

If a customer must loan funds to a supplier at low interest or no interest, interest will arguably have to be imputed and VAT paid on a matching additional consideration in order to reflect properly the actual price paid by the customer for goods and services. See the U.K. case of Exeter Golf Country Club Ltd. v. C&E Commissioners, 1981 Simon’s Tax Cas. 211 (C. A.); cf. IRC sec. 7872. Failure to make such an imputation will encourage taxpayer avoidance.

24. VAT would be avoided. Although the cost of these items may be reflected in the sales prices of a business and therefore in VAT collected, so would cash compensation to employees and cash gifts to customers. The problem is that a good or service would be furnished to an employee or a customer VAT-free if VAT is not charged by the business upon its furnishing the good or service and if the business is permitted purchase VAT credit with respect thereto.

25. Under the U.K. approach the nonbusiness use of goods is subject to tax. VATA 1983, 2 Sch. paragraph 5(3). Otherwise, the gift of a service is not subject to tax. Further, under the U.K. approach, free meals to employees, goods costing less than £10 given for business purposes and not forming part of a series of gifts to the same person, and gifts to actual or potential customers of industrial samples not ordinarily available for sale to the public are not subject to VAT. Otherwise, a gift of a business asset is subject to VAT. VATA 1983, 2 Sch. paragraph 5(2), 4 Sch. paragraph 10. If business gifts furnished to registered persons are subject to the VAT, either the recipient or the grantor should be able to claim credit for such VAT. In the United Kingdom the provider is permitted to issue a tax certificate to the registered recipient. C&E Press Notice No. 889, (March 1, 1984); F323, Paul W. DeVoil, Value-Added Tax (1989). An alternative to taxing employee fringe benefits and employee gifts would be to deny credit for the employer’s purchase VAT relating thereto. Such an approach would be difficult to administer. The Treasury Report (at pages 82 and 83) recommends such denial only in the case of purchases for gifts to employees and also recommends consideration of such denial in the cases of meals, drinks, and automobiles furnished to employees. The ABA Tax Section VAT Committee Report (at pages 46 and 164–165) does not tax business gifts. Further, this report (at pages 38 and 39) taxes employee fringe benefits only to the extent included in gross income under the federal income tax.

26. Such advertising is currently deductible for federal income tax purposes.

27. Such employee fringe benefits would generally include those giving rise to employer deductions and employee exclusions.

28. See note 17 above for a description of the U.K. retail schemes.
29. Under the U.K. VAT, the taxable event is generally the earlier of the rendering of the invoice, the payment for the goods or services, or the delivery of goods or services. VATA 1983 secs. 4, 5. The United Kingdom permits small businesses to elect the cash method. VATA 1983, 7 Sch. 2(3A); FA 1987 sec. 11(2); C&E Notice No. 731 (Oct. 1987). New Zealand law is similar to the United Kingdom's. New Zealand GSTA sec. 19.

30. U.K. persons surveyed (note 2) agreed that a business will prefer the cash method over the invoice method if it typically has credit sales and cash purchases (77 percent, 50 percent) but not if it typically has cash sales and credit purchases (73 percent, 48 percent).

31. See note 30 above.

32. U.K. persons surveyed (95 percent, 89 percent—note 2) agreed that an invoice method business purchaser is significantly encouraged to take delivery of its high-cost purchase items shortly before the end of a period instead of the beginning of the next period, assuming similar purchase terms.

33. VATA 1983 sec. 22; FA 1985 sec. 32; SI 1986/337. Formal bankruptcy might not be sought if a purchaser moves and becomes untraceable.

The noted problem for bad debts may be avoided in the United Kingdom if the business is a small business that uses the cash method. SI 1987/1427; C&E Notice No. 731 (Oct. 1987). Further, the problem may be avoided if the supplier uses one of several special retail schemes involving the “standard method of gross takings.” VATA 1983, 7 Sch. paragraph 2(3A); FA 1987 sec. 11(2); C&E Notice No. 727 (Oct. 1988). The U.K. persons surveyed (98 percent, 87 percent—note 2) agreed that a business will prefer the cash method over the invoice method if it is likely to have significant bad debts. They also agreed that separate incorporation of a separate business of a company (with no group registration) would have a significant VAT advantage if the business will probably have high uncollectible debts from future sales and will be able to use the cash method (100 percent, 72 percent) and that separate registration of divisions of a company would have a significant VAT advantage if one of the divisions may thereby be able to use the cash method (85 percent, 50 percent).

34. The United Kingdom does not make available an installment method for remittance of VAT on deferred payment sales. VATA 1983, 2 Sch. 1(2); VATA 1983 secs. 4, 5(1).

35. Rules may have to be enacted that defer the purchaser's credit in the case of related parties. Cf. IRC sec. 267(a)(2).

36. Cash flow and other advantages of vertical integration do not seem important if a current purchase VAT credit is available and is taken at the same time as the seller's remittance of sales VAT. However, vertical integration could be advantageous if the purchaser is partially exempt, if there is a denial or deferral of the purchase VAT credit, if the seller uses the accrual method and the buyer the cash method, or if the seller has minimal taxed purchases (as with an integrated oil company).

37. Although the taxation of transactions between divisions of a corporation and between related corporations would reduce the incentive to self-supply, this step represents formidable problems and had not been taken by the Europeans except in isolated cases. The Europeans have not dealt with the problem of vertical integration, in part perhaps because the European business integration has been primarily horizontal and because the VAT replaced turnover taxes that provided a much stronger incentive to integrate vertically.

The U.K. persons surveyed (81 percent, 57 percent—note 2) agreed that the advantage of a vertically integrated business over a competing nonvertically integrated business can be significant in certain instances. Moreover, the U.K. persons surveyed (61 percent, 37 percent) agreed that this advantage significantly encourages vertical integration in appropriate cases.

38. The U.K. persons surveyed (note 2) agreed on several situations in which a group registration for two companies is not likely to be sought: (1) if one of the companies has been using the cash method and the group will have to use the accrual method (86 percent, 41 percent); (2) when one of the companies engages in an exempt activity and the group will have to use the U.K. partial exemption rules (73 percent, 52 percent); and (3) when one or more of the companies supplies retail services and would otherwise not have to register (72 percent, 46 percent).

Group registration is advantageous in saving a considerable amount of paper work (invoicing and accounting for VAT) between members of a group. Group registration could also be
advantageous in achieving (as a group) the minimum amount of sales necessary for registration when voluntary registration is not permitted.

39. VATA 1983 sec. 29. In the United Kingdom registration is by partnerships and not by partners. VATA 1983 sec. 30(1).

40. SI 1985/886, Regs. 58(1) & (4), 60(b). However, the U.K. C&E commissioners may allow or direct a person to complete returns for a period of one month. SI 1985/886, Reg. 58(1)(a). In addition, small businesses may account for and pay VAT on an annual basis, the payments to be made in nine installments. SI 1985/886.

If the taxable period is three months but related corporations and other taxable persons are not required to have periods ending on the same month, costs could be channeled initially to the taxable person whose taxable period ends first. Benefit from the purchase VAT credit would thereby be accelerated. In the United Kingdom, accounting periods are prescribed according to trade classifications, although the taxable person can apply for periods that fit into his financial year. C&E Notice 700 (Oct. 1, 1987), paragraph 83.

A staggered payment system (as in the United Kingdom) in which different taxable persons make their quarterly returns in different months ensures that purchase VAT credit will often be made before the associated sales VAT payment.

If a business expected to incur regularly large purchases, it would wish to arrange its VAT return periods so that they fell reasonably close to the dates when the purchases were incurred and paid for, to minimize a cash flow effect of having to carry the purchase VAT.

41. See note 40 above.

42. Such a step would not be necessary if registration by divisions were freely available. The U.K. practice, however, is to make division registration freely available only when all divisions use the same tax period and meet certain other requirements. VATA 1983 sec. 31(1); C&E Leaflet No. 700/3/87 paragraph 2.

43. VATA 1983 sec. 29(5); C&E Leaflet No. 700/2/83 paragraph 9.

44. If a corporate group has a subsidiary that predominantly makes only zero-rated sales, the subsidiary could register separately and elect a one-month period while the remainder of the group (registered together) would elect a three-month period. The group could then be structured to channel costs initially through the subsidiary accounting for tax on a monthly basis (and obtaining a refund each month).

45. The United Kingdom exempts eleven activities (or groups), the principal ones being land (except sale of land by a person “constructing a residential building”), insurance, finance, education, postal services, and health and welfare. VATA 1983, 6 Sch. (Local governments or “authorities” are effectively zero rated and not exempted.) Many of the U.K. exemptions are required by law. EEC Sixth Directive articles 13A, 13B. In contrast, New Zealand exempts only four activities or groups. New Zealand GSTA sec. 14. It does not exempt insurance, education, postal services, or health and welfare.

46. Certain kinds of business activities might also be considered as being outside the VAT (for example, raising of funds through issuance of stock), with the result that input taxes are blocked and the activity has an exempt like status. See VATA 1983, 6 Sch. 5(6); C&E Notice No. 706 (Apr. 1987), paragraphs 9, 11.

47. The U.K. persons surveyed (81 percent, 65 percent—note 2) agreed that a registered nonretail business supplying goods has a significant advantage under the U.K. VAT over its nonregistered competitors.

48. The U.K. persons surveyed (72 percent, 50 percent—note 2) disagreed that the additional cost placed on domestic U.K. finance because of its exempt status significantly encourages nonbank companies to finance activities through equity instead of bank loans. Further, the U.K. persons surveyed (79 percent, 48 percent) disagreed that such an additional cost significantly encourages U.K. banks to locate part of their operations abroad to minimize taxable U.K. purchases.

Also, the U.K. persons surveyed (88 percent, 65 percent) disagreed that the additional cost placed on domestic U.K. insurance because of its exempt status significantly encouraged potential insures to self-insure. In addition, the U.K. persons surveyed (72 percent, 46 percent) disagreed that such an additional cost significantly encouraged U.K. insurance companies to locate part of their operations abroad to minimize taxable U.K. purchases.

In this connection, in the United Kingdom a business’s raising of capital is in effect exempt,
thereby increasing any taxed costs of financing by the VAT rate. See C&E Notice No. 706 (Apr. 1987), paragraphs 9, 10, 11.

49. See note 66 below.

50. Under the EEC VAT systems, financing through bank borrowing represents a supply by the bank but financing through issuing shares represents a supply by the company and not by the new investors.

51. See note 48 above. Assuming that 40 percent of the taxable outlays in providing domestic insurance in the United Kingdom is blocked, that a U.K. insurance company makes about a 10 percent profit on its costs through insurance premiums, and that the blocked VAT at 15 percent is passed through to customers, then about 5.7 percent of the domestic insurance protection of premiums is blocked VAT in the United Kingdom.

52. The U.K. persons surveyed (63 percent, 52 percent—note 2) agreed that exemption of an entity or an activity significantly encourages tax avoidance by its self-supply of its labor needs instead of contracting for these labor needs through a taxable business.

53. For example, should in-house legal or accounting services be taxed? If so, should the value of those services include overhead?

54. SI 1981/1741 article 14. The U.K. decision to take this self-supply was a political one, brought about by complaints from printers that they were likely to lose significant business otherwise. The U.K. Treasury has broad authority to tax self-supply of goods and services. VATA secs. 3(5), 3(6), 3(7). See note 83 below. The ABA Tax Section VAT Committee Report (at pages 175-177) contains a provision that permits the taxing of self-supply by an exempt activity "to the extent provided in regulations." Based on the U.K. experience, such regulatory authority is not likely to be exercised extensively and is likely to be exercised only because of political pressure from affected taxable suppliers.

55. VATA 1983, 6A Sch. paragraphs 5, 6, added by FA 1989, 3 Sch. The "value" of the supply must be in excess of £100,000. See also C&E News Release No. 47/88, Consultation Paper: VAT on Non-Domestic Construction (June 21, 1988), pt. D, in J.F. Avery Jones, Encyclopedia of Value Added Tax, 5-884. See also SI 1989/472 (self-supply of certain construction services subject to tax when the business using the facility is not fully taxable).

56. In the United Kingdom, when the insured's property is repaired, the supply is deemed to the insured and not to the insurer. C&E Leaflet No. 701/36/86 paragraph 15.

57. The U.K. persons surveyed (note 2) were generally evenly divided over whether the exemption of an entity or an activity significantly encourages tax avoidance by its leasing of expensive equipment from a taxable person instead of purchasing it.

58. See note 34 above and accompanying text.

59. The U.K. persons surveyed (note 2) were generally evenly divided over whether the exemption of an entity or an activity significantly encourages tax avoidance by its purchasing of shares of stock of a company with desirable assets instead of direct purchase of those assets. C&E has the power to impose open market value on transactions that have been undertaken between related parties at below-market value when the recipient is partially exempt. See note 60 below.

60. In the United Kingdom, C&E has the power to charge VAT on the fair market value of purchases by a person in an exempt activity from a related person. VATA 1983, 4 Sch. 1(1); FA 1987 sec. 17.

61. The U.K. persons surveyed (90 percent, 61 percent—note 2) disagreed that the nonregistered status of professional employees and their inability to claim purchase VAT credit significantly encourages VAT avoidance by such persons' incorporation of their trades to perform taxable services at fixed fees (for example, by accountants who work at home).

62. The U.K. persons surveyed (71 percent, 59 percent—note 2) disagreed that the nonregistered status of employees and their inability to claim purchase VAT credit significantly encourages VAT avoidance by such persons' having their employers purchase all or part of their taxable supplies (for example, tools of trade that could give rise to purchase VAT credit to the employer).

63. The ABA Tax Section VAT Committee Report (at pages 32 and 33) recognizes the described potential for distortion of economic decisions and describes possible approaches for avoiding or minimizing this distortion. It adopts neither of these approaches, however.

64. The 1984 Treasury Report (at p. 61) recommends required registration for all firms having an established place of business or making more than casual sales. It does not recommend exemption based on gross receipts or a similar criterion.
65. VATA 1983 sec. 48(1), 1 Sch. 1, 12; SI 1989/470. This amount assumes a conversion ratio of $1.67: £1. Thus, the registration limit £23,600 is equivalent to $39,400 at such a conversion rate.

   On March 31, 1989, there were approximately 1,624,000 registered persons in the United Kingdom. H.M. Customs and Excise 1989 Report, 52.

   New Zealand requires registration when, during a twelve-month period, sales exceed NZ$24,000; it permits voluntary registration below this threshold. New Zealand GSTA sec. 51.

66. The U.K. persons surveyed (84 percent, 70 percent—note 2) agreed that if a retail business in a labor-intensive activity does not have to register, it has a significant advantage over a registered competitor.

67. In cases such as these, the United Kingdom considers the value of the product sold by the distributor to the salesperson to be the retail sales price and not the wholesale price paid by the salesperson. See C&E VAT Leaflet No. 700/16/82. Furthermore, if a business gives rewards of goods or services to agents and hostesses either free of charge or at specially discounted prices, VAT is generally to be accounted for on the basis of the open market value of such goods or services.

68. In the United Kingdom, the C&E commissioners have authority under specified avoidance conditions to aggregate the activities of individuals or corporations when they are part of the same business (that is, when the activities are not independent). VATA 1983, 1 Sch. paragraph 1A; FA 1986 sec. 10; C&E Press Notice No. 762 (Sept. 20, 1982); F314, Paul W. DeVoil, *Value Added Tax* (1989).

   The U.K. persons surveyed (86 percent, 80 percent—note 2) agreed that the VAT advantage that a nonregistered retail business has over its registered competitors encourages a person's incorporating different small businesses to avoid the U.K. threshold for required registration. The U.K. persons surveyed (79 percent, 48 percent) agreed that separate incorporation of a separate business of a company (with no group registration) would have a significant VAT advantage if the business performs retail services and would not have to register when separately incorporated. See also note 38 above.

69. Present U.K. law, which may conflict with the Sixth Directive of the European Economic Community, does not permit a credit for some prebusiness costs. SI 1985/886, Reg. 37; SI 1987/510, Reg. 2; C&E Leaflet No. 700 (Oct. 1, 1987), paragraph 38.

70. Partial exemption rules could affect business decisions in ways other than noted in the text. For example, the U.K. persons surveyed (note 2) agreed that the partial exemption rules will significantly encourage taxpayers, in many cases, to segregate unrelated exempt and taxable activities into different entities (79 percent, 67 percent) and, in many others, to aggregate exempt and taxable activities into one company or to seek group registration for related companies (76 percent, 61 percent).

71. The C&E is likely to follow the taxpayer's non-VAT approach. It has authority to specify a method in order to secure a fair and reasonable apportionment. SI 1985/886, Regs. 30(1), 30(4); SI 1987/510. It also has the authority to permit special allocation methods other than the standard method. SI 1985/886, Regs. 30(5), 36(2); SI 1987/510.

72. The U.K. persons surveyed (74 percent, 43 percent—note 2) agreed that separate incorporation of a separate business of a company (with no group registration) would have a significant VAT advantage if the business is exempt and the company would otherwise have to use the U.K. partial exemption rules.

73. This was the former U.K. rule. VATA 1983 sec. 15(1) (before amendment).

74. See note 7 above and the text accompanying note 179 below.

75. The model act of the ABA Tax Section VAT Committee Report, sec. 4011(e), uses an approach that modifies this formula for businesses engaged in gambling and other games of chance. This model act taxes gross receipts from games of chance reduced by payments to winners. The tax so computed is reduced by a credit for purchase VAT. The formula for determining the payable VAT would be—

   \[
   (\text{VAT Rate} \times (\text{Gross Receipts} - \text{Winners Payments})) - \text{Purchase VAT}
   \]

   The report's partial explanation (at pages 56-57) for this approach is that it taxes only the value added by the business. The approach is subject to criticism, however, because it generally results
in gross receipts of a "retail" gambling business not being fully taxed. In contrast, the gross receipts of other retail businesses are in effect fully taxed, either at the retail level or at a prior level. (In the United Kingdom, games of chance are generally exempt (VATA 1983 sec. 17(1), 6 Sch. group 4), perhaps because gambling is subject to a separate tax in the United Kingdom. In New Zealand, the amount received (that is, paid to participate) is subject to VAT. New Zealand GSTA sec. 5(10).)

76. The United Kingdom permits such an election. VATA 1983 sec. 14(1) and 7 Sch. paragraph 2(1); SI 1988/866.


78. The requirement also avoids the need for tour operators to register in different EEC countries.

79. It would ordinarily be far easier in cases involving interstate corporations for a purchaser to seek a credit based on the location of its purchase than on the location of its value added or the location of its sales.

80. NEDO Report, 38–39. The EEC Council Directive (article 18, paragraph 4 (May 17, 1977)) permits member states to carry forward excess credits (in lieu of a refund) "according to the conditions which they shall determine."

81. See IRC secs. 1361–1379.

82. The lag system was used in France. See NEDO Report, 29.

83. SI 1981/1741 articles 2, 9. The U.K. persons surveyed (note 2) agreed that in the United Kingdom a tax on self-supply is justifiable in the following credit denial situations: (1) use of cars by a car manufacturer (92 percent, 72 percent), (2) operation by a manufacturer of a facility for entertaining customers (77 percent, 52 percent), and (3) printing of forms by an exempt insurance company (69 percent, 52 percent). However, they were generally divided that in the United Kingdom a tax on self-supply is justifiable in the case of cleaning costs of an exempt insurance company for its headquarters building.


85. This approach was considered, but not recommended, by the 1984 Treasury Study at pages 64–67 (agriculture) and 75 (certain construction). The U.K. persons surveyed (84 percent, 35 percent—note 2) agreed that an imputed purchase VAT credit for purchases from certain partially exempt business taxpayers (for example, a credit for 9 percent of maritime-aviation-transportation insurance premiums paid to EEC insurance companies) could be effective in mitigating any harm caused by such partially exempt status.


87. The U.K. persons surveyed (note 2) agreed (1) that an imputed purchase VAT credit based on wages paid (e.g., 15 percent of the first £10,000 of wages paid each employee) would effectively encourage the hiring of employees (76 percent, 63 percent), (2) that an imputed purchase VAT credit on the discovery value of specified minerals would effectively encourage exploration for such minerals (79 percent, 59 percent), and (3) that an imputed purchase VAT credit on wages paid in research and experimentation would effectively encourage research and experimentation (83 percent, 63 percent).

88. See Smith, Webber, and Cerf, 26. The model statute of the ABA Tax Section VAT Committee Report (at pages 10 and 11) argues for, and assumes, the granting of an immediate credit on capital purchases.

89. Availability or denial of the credit would obviously have an impact on the capital-labor mix in industries in which production factor coefficients were sufficiently elastic.

In the United Kingdom the Treasury by statutory instrument may deny the credit for purchase VAT (VATA 1983 sec. 14(10)), but this authority has been used sparingly. See note 91 below and accompanying text.

90. The EEC Sixth Council Directive (article 17, paragraph 7 (May 17, 1977)) recognizes that purchase VAT may have to be denied as a credit "for cyclical economic reasons." See note 93. Denial of credits could also be used to favor an activity, product, or asset over a competing activity, product, or asset. For example, if the government wished to encourage rehabilitation of buildings over new construction, credits relating to new construction could be denied in whole or in part. In this connection, the U.K. persons surveyed (note 2) agreed that exempting new building construction (that is, denying credit to the constructor or the owner), but permitting
credit for rehabilitation, would significantly encourage rehabilitation over new construction as to both commercial building (85 percent, 72 percent) and residential buildings (81 percent, 63 percent).

91. As to automobiles, see SI 1980/442 article 4. As to entertainment, see SI 1981/1741 articles 2 and 9.

92. See note 98 below. The U.K. persons surveyed (note 2) disagreed that denial of the credit for purchase of cars in the United Kingdom has significantly discouraged the purchase of cars by business (80 percent, 76 percent) or effectively mitigates the effect of the income tax on personal use of business cars by owners and employees (69 percent, 54 percent), but they were generally divided that such a denial is a disproportionate response to the problem.

93. The U.K. persons surveyed (note 2) disagreed that denial of a credit for purchase VAT on a class of business assets would significantly discourage the purchase of such assets (54 percent, 43 percent), but they agreed that such denial would significantly encourage leasing over purchasing of such assets when the lessee’s credit is not limited (73 percent, 59 percent) and would significantly encourage self-supply on such assets (assuming that self-supply is not subject to taxation) when high labor costs are involved (84 percent, 67 percent).

94. VATA 1983, 6A Sch., added by FA 1989, 3 Sch.; see also note 55 and accompanying text.

95. As in the case of the income tax, one deviation from neutrality would serve to set off a chain reaction of nonneutral effects.

The acquisition and disposition of equity interests raises some difficult questions. Should the VAT apply to the transfer of noncash property to an entity in exchange for an equity interest? If the transfer is viewed as the equivalent of the sale of the property for cash and of the transfer of cash for the equity interest, the VAT arguably should apply if the sale of the property would be subject to VAT. If income tax law is any guide, there will be rules for noncoverage, but these will be more liberal in the case of partnerships. If a business sells or exchanges an equity interest, should the VAT apply to the disposition? Are the entity and the nature of its property, as in the case of a real estate partnership, material? Similarly, if the entity distributes noncash property to its shareholders or partners (whether or not in reduction of the owners’ pro rata equity interest), should the VAT apply to the transfer? (The United Kingdom would tax such a transfer. VATA 1983, 2 Sch. 5(1)(3), 4 Sch. 7, 8.) Again, if income tax law is any guide, there will be different rules for partnerships and for corporations. If any of the foregoing transfers are not covered, the appropriate technique would seem to be zero rating. If, on the other hand, the foregoing transfers are covered, the transaction might give rise to no credit to the transferee or to a credit that is not immediately refundable. To the extent that the coverage rules for partnerships and for corporations differ, as in the case of the income tax law, the VAT will affect the choice of business form.


97. The U.K. persons surveyed (note 2) agreed that required amortization (in place of an immediate credit) of purchase VAT on a class of business assets would probably encourage leasing over purchasing of such assets if the lessor’s credit is not so limited (81 percent, 63 percent) and would probably encourage self-supply of such assets (assuming that self-supply is not subject to taxation) when high labor costs are involved (83 percent, 65 percent). However, they were generally divided that such required amortization would probably discourage the purchase of such assets or would probably discourage excessive estimations of taxable use by a partially exempt taxpayer (as might occur if immediate credit were permitted).

98. Assets that could be acquired for mixed personal and business (or investment) reasons include automobiles, yachts, aircraft, personal computers, residences, farms, jewelry, antiques and other collectibles, and art.

The ABA Tax Section VAT Committee Report (at pages 182 and 183) recommended a special status for an “investment custody account,” composed of investment assets and managed by a trustee to ensure that personal use cannot occur. Under this approach the purchase VAT credit would be granted currently on investment assets acquired by such a trust.

99. See note 148 below.

100. NEDO Report, 34–35.

101. Ibid., 34.
104. VATA 1983, 5 Sch. 9, items 5, 6(a); C&E Notice No. 741 (June 1987). Arrangements exist under the EEC Eighth Directive whereby tax incurred in one member state can be reclaimed in a second, so that taxable recipients of such services are no worse off than if the services had been supplied by someone in the second state. EEC Eighth Council Directive article 2 (Dec. 6, 1979).
105. The General Agreement on Trade and Tariffs may impose restrictions.
106. See note 116 below.
107. The United Kingdom permits such an election. VATA 1983, 7 Sch. 2(3A); SI 1987/1427; C&E Notice No. 731 (Oct. 1987). Other provisions that may benefit small business in the United Kingdom are (1) no required registration if gross receipts do not exceed £23,600 (VATA 1983 sec. 48(1), 1 Sch. 1, 12; SI 1987/438), (2) voluntary registration for persons not required to register (VATA 1983, 1 Sch. paragraphs 11(1)(b), 11(2A), 11(3); FA 1984 sec. 12(2)), and (3) annual returns with payments on account (VATA 1983 sec. 14(1) and 7 Sch. 2(1); SI 1988/886).
108. IRC secs. 263(c) (intangible drilling and development costs), 611-614 (depletion).
110. See note 12 and appendixes A, B, and C above (pages 39, 41, and 43) for the European experience.
111. For the fiscal year ending March 31, 1988, the cost of administering the U.K. VAT was 1.02 percent of revenues collected. H.M. Customs and Excise 1988 Report. In contrast, the net compliance costs (after positive benefits such as cash flow) of the U.K. VAT to business are estimated at about four times the costs of administration. These compliance costs vary according to the type and size of the business involved. See Cedric Sanford et al., *Costs and Benefits of VAT* (Great Britain: Heinemann Educational Books, 1981).
112. The model statute of the ABA Tax Section VAT Committee Report (at page 11) argues for, and assumes, accommodation of social and economic concerns outside the VAT.
113. The U.K. experience is instructive. See notes 4 and 12 above.
115. The U.K. persons surveyed (note 2) were questioned about the elements of an efficient and effective VAT in the context of real estate. They generally agreed about the following elements suggested to them: (1) standard rated: civil engineering works (87 percent, 72 percent), new construction and improvements (78 percent, 63 percent), repairs (92 percent, 76 percent), and rental of commercial (including transient rental) (94 percent, 67 percent); (2) exempt: unimproved value of land (70 percent, 46 percent), subsequent sales ("used buildings") (65 percent, 52 percent), and residential rental (71 percent, 54 percent); (3) nontaxable: imputed rental value of owner-occupied residences (91 percent, 70 percent); and (4) special provision: change from owner-occupied residential to commercial, or vice versa (82 percent, 39 percent).
116. The U.K. persons surveyed agreed (note 2) that it would be significantly inefficient either (1) to specify a lower rate on certain purchases by an exempt or nontaxed entity or activity (90 percent, 80 percent) or (2) to specify a lower rate on certain purchases by a partially exempt entity or activity (95 percent, 83 percent). In this connection, techniques could be sought to minimize this inefficiency (for example, by giving the entity or activity a special registration number). The EEC is now recognizing that in its situation a range of rates is not desirable. A recommendation being considered is for two rates (other than the zero rate), that is, a lower rate (4 percent to 9 percent) and a standard rate (14 percent to 20 percent). The more positive VAT rates there are, the more
complex the taxable person’s accounts have to be. As a result, (1) compliance and administrative costs will rise, (2) possibilities of innocent error increase, and (3) possibilities of deliberate misstatement increase.

117. The 1984 Treasury Report (at pages 49-53) expresses reservations about exempting banks, savings associations, and insurance companies. It unqualifiedly recommends exemption only in limited cases. For example, it recommends exemption of taxi service. See 1984 Treasury Report, 55. See notes 20 and 45 above for the practice in the United Kingdom and in New Zealand.

The U.K. persons surveyed (92 percent, 78 percent—note 2) agreed that minimal use of exemptions and zero rating will substantially promote efficiency. However, as to the major zero-rated groups (pre-Finance Bill of 1989), their expressions of support for the proposition that the standard rating of each would substantially promote efficiency were not as strong: food (agreed 67 percent, 48 percent); sewerage services and water (divided) (limited by the Finance Bill of 1989 to nonbusiness customers), books, magazines, and other printed matter (agreed 74 percent, 50 percent); fuel and power (agreed 64 percent, 39 percent) (limited by the Finance Bill of 1989 to residential and charitable use); buildings and civil engineering works (agreed 76 percent, 54 percent) (limited by the Finance Bill of 1989 to construction for residential or charitable purposes); and exports (disagreed 68 percent, 46 percent). Moreover, as to the following major exempted groups previously identified (note 45 above), their expressions of support for the proposition that the standard or zero rating of each would substantially promote efficiency were also not as strong: land (agreed 79 percent, 50 percent), insurance (agreed 86 percent, 54 percent), postal services (agreed 58 percent, 33 percent), finance (agreed 78 percent, 46 percent), education (agreed 64 percent, 35 percent), and health and welfare (agreed 58 percent, 30 percent).

118. The U.K. persons surveyed (note 2) differed over whether domestic insurance should be exempted. They also differed over whether, as an alternative to exemption of insurance, premiums should be subject to a low rate (for example, one percent), with no VAT being charged on payments for damages and with the insurance company being entitled to full credit for its purchase VAT. However, they disagreed (70 percent, 35 percent) that if domestic insurance is exempt, purchase VAT on insurance premiums should be imputed to taxable insureds, in recognition of the VAT content in insurance premiums. The U.K. practitioners surveyed also differed over whether, if domestic insurance is exempt and foreign insurance is zero rated, a uniform (insurance industrywide) percentage or uniform percentages should be developed apportioning purchase VAT of insurance companies between domestic and foreign.

119. Insurance companies and banks are highly computerized, and there should be no problem in applying the VAT to their operations.

Suggestions have been made in the EEC (and are being pursued in the United Kingdom) that the VAT be levied on bank charges other than interest, by use of the option to tax that is currently available. EEC Sixth Directive articles 13B(d), 13C.

120. The U.K. persons surveyed (88 percent, 80 percent—note 2) agreed that zero rating an activity is justifiable for social reasons, to minimize the impact of VAT on the activity. However, they disagreed that zero rating an activity is justifiable (1) only if difficult administrative or compliance problems are not created thereby (68 percent, 54 percent), (2) when the VAT is difficult to apply (73 percent, 59 percent), (3) when the activity has both business and nonbusiness customers and when its purchase VAT is not significant in relation to its total purchases (69 percent, 52 percent), or (4) when there are a large number of small suppliers and the amount of goods purchased by each is not significant (76 percent, 54 percent). The U.K. persons surveyed (58 percent, 48 percent—note 2) agreed that exempting an activity is justifiable only if difficult administrative or compliance problems are not created thereby. They also agreed on the following rationales for exemption: (1) when necessary to minimize the impact of VAT on an activity (77 percent, 65 percent), (2) when the VAT is difficult to apply (62 percent, 52 percent), and (3) when the activity has both business and nonbusiness customers and when its purchase VAT is not significant in relation to its total purchases (59 percent, 41 percent). However, they disagreed (55 percent, 39 percent) that exemption is desirable when there are a large number of small suppliers and the amount of goods purchased is not significant.

121. See note 118 above.

122. The U.K. persons surveyed (note 2) disagreed that the return period for the largest companies
should be one month (73 percent, 65 percent) but agreed that the return period for the smallest companies should be one year (61 percent, 59 percent).

123. Under the European forfait system, the business remits estimated taxes (based on the prior years' results) over a ten-month period, with an end-of-year adjustment based on the end-of-year determination of value added.

The U.K. persons surveyed (76 percent, 63 percent—note 2) agreed that the forfait system would work efficiently for small business. The forfait system is not dissimilar to the U.K. annual accounting system, which only some 5,000 businesses have chosen to use. VATA 1983 sec. 14(1); FA 1987 sec. 11(1); SI 1988/886.

124. See note 40 above and accompanying text.

125. The U.K. persons surveyed (note 2) disagreed that a company should be required to use the invoice method or the cash method, depending on the method used in preparing either the company's financial statements (70 percent, 41 percent) or its income tax returns (75 percent, 46 percent).

126. Cf. IRC sec. 267(a)(2).

127. In the United Kingdom auditing is not done extensively using invoices. Instead, auditing techniques similar to those under the income tax are used (for example, analysis of accounts). Further, the U.K. VAT does not rely on invoices under certain of the retail schemes. See also note 128.

Giving central importance to the invoice may make the revenue agency reluctant to deal with techniques that are not invoice-related (for example, the imputed credit on used property). See textual discussion relating to note 181.


129. If the credit allowed for purchase VAT on capital goods is to be amortized over the useful life of the property, the income tax useful lives could be used for VAT purposes, or vice versa.

130. The U.K. persons surveyed (69 percent, 54 percent—note 2) agreed that it is possible to construct a VAT system based on each taxpayer's accounting records when the system does not place primary emphasis on invoices. Of those in agreement, most also agreed that such a system would not impose disproportionate administrative costs on C&E (60 percent) and would result in substantial savings in compliance costs (62 percent).

131. Required information on U.K. invoices is limited to eleven items. Reg. 13, SI 1985/886; C&E Notice No. 700 paragraph 47 (Oct. 1, 1987). The U.K. persons surveyed (61 percent, 48 percent—note 2) disagreed that C&E requirements for information on the invoices are too extensive.

132. The U.K. persons surveyed (83 percent, 63 percent—note 2) agreed that VAT definitions and concepts, except when impractical, should be based on accounting concepts. However, they disagreed that they should be based on income tax concepts (66 percent, 46 percent) and differed on the desirability of being based on customs (C&E) concepts.

The U.K. persons surveyed (note 2) agreed that the definitions of the following items create substantial taxpayer confusion: children's clothing (79 percent, 57 percent), builders' fixtures (89 percent, 72 percent), and printed matter (69 percent, 48 percent). They were not interviewed on other definitions. The U.K. persons surveyed (note 2) agreed that the U.K. rules in the following areas would of necessity require that professional assistance be available to smaller business: retail schemes (73 percent, 48 percent), compound supplies (involving products subject to different VAT treatment) (77 percent, 59 percent), partial exemption (92 percent, 78 percent), international services (86 percent, 70 percent), and business/nonbusiness distinctions (83 percent, 63 percent). They were not interviewed about other areas of potential complexity.

133. See Turnier, "Designing an Efficient Value Added Tax," 458-60; note 65 above (practice in the United Kingdom and New Zealand). But see note 64.

The U.K. persons surveyed (83 percent, 63 percent—note 2) agreed that increasing the required registration level to £50,000 (presently at £23,600) would substantially promote efficiency, but they were generally divided over the efficiency of permitting small businesses to register (when not otherwise required to register). However, they were nearly unanimous (97 percent, 76
percent) that if such small businesses are permitted to elect to register, there should be neither a rebate to them to meet compliance costs nor a charge to them to meet administrative costs.

134. Deregistration should probably give rise to a partial or complete recapture of purchase VAT credits on existing property. Similarly, registration should arguably give rise to a partial or complete granting of purchase VAT credits on existing property. The United Kingdom provides for these results. VATA 1983, 2 Sch. 7 and 4 Sch. 7; VATA 1983 sec. 14(9)(b); SI 1985/886, Reg. 37; SI 1987/510, Reg. 2. See section titled "Changed Use" in chapter 4. The United Kingdom also permits "intending traders" to register, thereby permitting such persons a current purchase VAT credit. VATA 1983, 1 Sch. 5, 5A; FA 1988 Sec. 14(4); SI 1985/886, Regs. 5–7.


136. See note 133 above.

137. In the United Kingdom the VAT is administered by C&E while the income tax is administered by Inland Revenue. However, the reasons for the U.K. arrangement are largely that the U.K. VAT replaced the purchase tax administered by C&E and that at the time of enactment of the VAT the Inland Revenue was burdened by recent substantial changes in the income tax law. Moreover, the VAT was viewed as a transactions tax calling for emphasis on physical evidence (i.e., invoices).

The U.K. persons surveyed (note 2) agreed or disagreed with the following statements about C&E and its practices: disagreed that C&E has sufficient staff (64 percent, 50 percent), disagreed that staff compensation is sufficient (67 percent, 74 percent), disagreed that computer power of C&E is sufficient (67 percent, 52 percent), agreed that C&E notices are adequate and helpful (67 percent, 61 percent), and agreed that detailed provisions should be dealt with through delegated or primary legislation and not through notices and leaflets (76 percent, 67 percent). They were generally divided that filings (including tax returns) should be with the local office.

138. The ABA Tax Section VAT Committee Report (at pages 166–174) does not have a final position on banking and insurance intermediation services. In this connection, such services in the domestic market are exempted by the United Kingdom and zero rated in the international market. See VATA 1983 secs. 7, 16, 5 Sch. paragraph 9(6)(b)-(d), 6 Sch. paragraphs 2, 5.

Further, the model act of the ABA Tax Section VAT Committee Report (sec. 4014 and pages 81–86) exempts property or services furnished by a government entity or an income tax-exempt entity when no charge is imposed (and to the extent to be provided in regulations, when only a nominal charge is imposed). Thus, the provision of police protection would generally be exempted, while the provision of water (for which a reasonable charge is made) would be fully taxable. The covered entities could thus be wholly or partially exempted. See note 119 above.

139. If exemption were being considered for domestic financial services performed by banks, savings associations, insurance companies, and other lending businesses, the revenue to be collected under the exemption approach could be estimated (that is, the noncreditable purchase VAT of these businesses). In place of exemption of these businesses, a low VAT rate could be set on interest and other charges of lending businesses that (after credits to business purchasers) would approximate the revenue to be collected under the exemption approach. Lenders who would be subject to the low VAT rate would have to be defined because other lenders would presumably be exempt (or not registered) as to their lending activities. Alternatively, all lenders would be subject to the low VAT rate (with special VAT withholding by the "borrower" for savings accounts, certificates of deposit, and securities), but limitations on purchase VAT credit would be imposed.

140. See note 118 above.

141. Cf. IRC sec. 280F. The 1984 Treasury Report (at page 83) stated that there is merit in disallowing the credit for VAT paid by a firm for meals and drinks under all circumstances and that the same policy should be considered for automobiles. The ABA Tax Section VAT Committee (at pages 161–163) recommends that when the owner of a business makes personal use of its property or services, the fair market value of the use (and not its cost to the business) be subject to the VAT. It does not recommend as an alternative either that the business's credit for purchase VAT relating thereto be denied and the owner's use not be taxed (in effect, exempting the transaction) or that the cost to the business of the property or service be the measure of its value. A comparable problem is presented under the federal income tax. When personal use is made of assets of a corporation by a shareholder, the shareholder will generally be taxed on a dividend or compensa-
tion under IRC sec. 61 equal to the value of such use. In contrast, when personal use is made of assets of an unincorporated proprietorship by its owner, deductions could be limited or denied under such IRC sections as 162, 183, and 280A. The two approaches of the federal income tax are probably simpler to administer than the ABA Tax Section VAT Committee Report approach, without consideration of other circumstances, in those cases in which the entire credit for purchase VAT is not to be denied.

142. The United Kingdom taxes self-supply of automobiles by manufacturers and dealers. The United Kingdom does not tax automobiles used by manufacturers for research and development purposes. VATA 1983 sec. 3(5); SI 1980/442 article 5. Complications potentially arise if the final user is a nonleasing business that permits its owners or employees to use the automobile. Strict adherence to theory would require that VAT be charged on the rental value of the automobile to the owner or employee and that the business be given a credit for part of its purchase VAT. However, except in the case of the manufacturer and dealers permitting owner and employee use, a strict adherence to theory may prove inefficient. In the United Kingdom, by special concession VAT is imposed on owner and employee use of automobiles only on any charges made. C&E Leaflet 700 (Oct. 1, 1987), appendix C, paragraphs 6, 7. This concession seems contrary to VATA 1983, 2 Sch. paragraph 5(1),(3).

143. See notes 83 and 91 and accompanying text.

144. Although the U.K. VAT was enacted in 1972, the United Kingdom did not make a proposal to deal with changed use until 1988. See Her Majesty's Customs and Excise, Consultation Paper: VAT-Input Tax: Origin and Scope of the Right to Deduction of Input on Capital Goods: Adjustment After the Initial Deduction (London: C&E, 1988), announced in C&E Press Notice No 9/88, (Feb. 29, 1988). A draft statutory instrument has been proposed and circulated among interested parties. The proposed coverage of the draft statutory instrument is limited. (See note 148 below.) The EEC Sixth Council Directive (article 20 (May 17, 1977)) contemplates an adjustment period of only five years, which may be extended to ten years in the case of immovable property. See text accompanying note 99.

If rates have changed, the credit to be granted or recaptured upon conversion of property could be determined under the new rates. The prior purchase VAT could be determined under the new rates. The prior purchase VAT could be converted by multiplying it by the following fraction: new rate/prior rate. However, it is desirable to use the prior rates (and not recompute the prior credit), in part because this approach is simpler than converting to the new rate but also because it is fair. See note 146 below.

145. The U.K. draft statutory instrument will affect only a relatively small number of changed use transactions. See note 148 below; see also note 146 below.

146. Under changes made by the Finance Bill of 1989 (applicable generally to buildings constructed after April 1, 1989) the United Kingdom generally standard rates construction of buildings but continues to zero rate construction solely for residential or charitable purposes. VATA 1983, 5 Sch. group 8. (In the United Kingdom, therefore, construction for residential and charitable purposes is favored.) Change of a building’s use from solely residential or charitable purposes within ten years after its construction will give rise to standard rating (that is, a recapture) (which will adversely impact exempt activities) under different approaches: (1) The conversion of a zero-rated building to a nonqualifying purpose (that is, not solely a residential or charitable purpose) will be treated as a self-supply subject to taxation under the rates and valuation existing at the time of construction. VATA 1983, 6A Sch. paragraphs 4–6. Thus, although the U.K. law uses the original rates and valuation, it does not utilize the earning-out technique described in the text. (2) Further, if a person sells a zero-rated building and if the purchaser is to use the property for a purpose other than solely residential or charitable, the sale is standard rated and not exempted. VATA 1983, 6A Sch. paragraphs 2, 3. In this context U.K. law thus does not use the original rates and valuation but uses the fair market value technique described in the text. (3) However, a change to solely residential or charitable purposes for a building does not give rise to zero rating (that is, a granting of a credit). See also note 55 above and the accompanying text.

147. The ABA Tax Section VAT Committee Report (at pages 100–101 and 113) would permit credit for purchase VAT on the shift from exempt to taxable use, apparently for the full purchase VAT. The credit for purchase VAT apparently would not be reduced to take into account the length of the exempt use or any decrease in value of the property.

148. The earning-out technique has been proposed in the U.K. See Her Majesty's Customs and

The U.K. persons surveyed (65 percent, 48 percent—note 2) agreed that in dealing with the problem of changing use, it would be efficient to grant an immediate credit (in the period of purchase) based on estimated use, subject to recapture based on actual use over a specified period. They generally differed, however, over the proposition that if initial use is exempt or partially exempt the potential credit for purchase VAT must be amortized over a specified period and allowed based on actual use each period. Finally, they agreed (76 percent, 48 percent) that the relevant period for recapture or amortization should be five years for all assets and disagreed (74 percent, 37 percent) that it should be five years for personality and ten years for realty. See also note 146 above.

149. Cf. IRC sec. 460(b)(3) (look-back method).

150. In the United Kingdom, if business goods (or other goods for which a credit has been granted) are put to private use on either a permanent or a temporary basis, purchase VAT is due. VATA 1983, 2 Sch. paragraphs 5(1)–5(3), 4 Sch. paragraphs 7, 8. But see notes 142 (private use of business automobiles) and 146 (construction for residential or charitable purposes) above.

A third technique would be to treat the conversion from taxable to exempt or personal use as a lease by a taxable person to someone for an exempt or personal use. However, this technique raises substantial administrative and compliance problems in determining a fair rental. Further, the effect of this technique is principally to defer remittance of the VAT, if the prior purchase VAT credit is not disturbed but the imputed lease rentals give rise to noncreditable VAT. (This statement is based on the assumption that purchases of property for lease for exempt or personal use will give rise to a current credit. However, if purchases of property for lease for exempt or personal use would give rise to a deferred credit and not to an immediate credit, consistency requires that on conversion treated as a lease, the prior purchase VAT should be recaptured and the conversion transaction treated as a purchase for re-lease. Thus, the imputed purchaser-lessee’s purchase VAT credit would be amortized and would largely match the VAT charged on the imputed rentals.)

151. The ABA Tax Section VAT Committee Report, sec. 4038, adopts this approach.

152. Notes 148 and 150 above.

153. This technique is being considered by the United Kingdom in dealing with the problem of mixed use, but without adjustments to the initial (unearned) credit. See note 148 above; see also note 146 above.


155. Taxpayers will be encouraged to give reasonable estimations of taxable and exempt or personal use. However, the charging of interest will not discourage the use of leasing subsidiaries and other related parties purchasing property for re-lease for exempt or personal use.

156. According to one U.K. practitioner, experience in the United Kingdom suggests that when the third method (earning out, estimated initial use subject to adjustment) is introduced, taxable persons making large capital purchases will consider establishment of “in house” leasing operations to obtain an initial 100 percent credit and to eliminate the administrative complexities of accounting for VAT over the period of adjustment. (The United Kingdom does not have the equivalent of anti-avoidance measures proposed in the discussion in the section titled “Leases and Deferred Payment Sales.”)

157. See discussion of mixed use property in the section titled “Changed Use” (the discussion to which notes 144 through 156 relate). For other possible deferred credit situations, see “Amortization” in the section titled “Capital Goods” (the discussion to which notes 96 through 98 relate).

158. Cf. IRC sec. 178 (amortization of cost of acquiring a lease over its life).

159. See text accompanying notes 154 and 155.


161. See text accompanying notes 89–92.
162. See text accompanying notes 45–79.
163. See text accompanying note 9.
164. See note 91 and accompanying text.
166. Cf. IRC secs. 168(h) (new), 168(j) (old) (leases to tax-exempt organizations).
167. Cf. IRC sec. 178 (amortization of cost of acquiring a lease over its life).
168. The United Kingdom requires the current remittance of the full sales VAT on deferred payment sales. VATA 1983, 2 Sch. paragraph 1(2); VATA 1983 secs. 4, 5(1).
171. Mixed use property is within the VAT ring to the extent that the credit for purchase VAT thereon has been granted (and not recaptured). It is outside the ring to the extent that credit has been deferred or denied (including any recapture of credit). (See section titled “Changed Use” in chapter 4.)
172. It would also be appropriate for the business seller to claim any remaining deferred credit on the sold property.
173. The European Commission of the EEC has published a draft proposal for a harmonized treatment of used goods throughout the EEC.
174. For example, an income tax surcharge could be imposed on covered dispositions. Other methods for increasing the income tax on covered dispositions would be to deny a stepped-up basis on death, deny nonrecognition provisions, or deny both, in computing the regular income tax or any special surcharge on covered dispositions. In addition, if favorable capital gains treatment is restored, this treatment could be denied on covered dispositions.
175. See section titled “Exemption” in chapter 1.
176. Exemption could also not be made available to mixed use property.
177. See note 8 above.
178. Automobiles, certain collectibles (works of art, antiques, and collector's pieces), motorcycles, motor homes, boats and outboard motors, aircraft, electric organs, firearms, and horses and ponies. VATA 1983 sec. 18; SI 1980/442; SI 1981/1741; and SI 1983/1099. The U.K. persons surveyed (note 2) disagreed that there is a substantial double VAT taxation because of the failure to extend the margin scheme to used computers (68 percent, 46 percent) or scrap metal (68 percent, 37 percent).
179. See note 8 and the text accompanying note 74.
180. However, the business could be given a credit upon its eventual disposition of the property.
181. See note 127 and accompanying text. The U.K. persons surveyed (61 percent, 30 percent—note 2) disagreed that the U.K. margin scheme on used goods should be replaced with an approach that imputes a fully creditable purchase VAT for used consumer goods.
182. See note 174 above.
183. The U.K. government has proposed that the fifth technique be used for mixed use assets having an initial purchase price above a de minimis amount (not specified). Her Majesty’s Customs and Excise, Consultation Paper: VAT-Input Tax: Origin and Scope of the Right to Deduction of Input Tax on Capital Goods: Adjustment After the Initial Deduction (London: C&E, 1988). See C&E Press Notice No. 9/88 (Feb. 29, 1988). A draft statutory instrument has been proposed and circulated among interested parties. The proposed coverage of the draft statutory instrument is limited. (See note 148 above; see also note 146 above.)
184. The United Kingdom has proposed this approach for mixed use property. See note 183; see also note 153 and accompanying text; in addition, see note 146 above.
185. A type of inflation adjustment could result if interest were payable on any deferred credit not previously allowed.
186. An example of this inequity is as follows: Assume that the threshold amount is $50,000 and that the VAT rate is 10 percent. Assume further that A, a nondealer, purchased an antique car for $30,000 from a dealer in antique cars and thus had to pay purchase VAT of $3,000. A later sold this antique car for $45,000 to B, another nondealer, and did not have to collect sales VAT because B is a nondealer. Finally, B sold the antique car to C (who is either a dealer or a nondealer) for $60,000. B must collect $6,000 from C under the revived credit technique and must also remit $6,000 because no VAT was paid by B on his prior purchase.
187. The 1984 Treasury Report (at pages 79 and 80) apparently recommends exemption in most out-in situations. However, in the case of used automobiles it recommends the imputed credit. In contrast, the ABA Tax Section VAT Committee Report (at pages 102–107) recommends the imputed credit for out-in situations.

The 1984 Treasury Report would apparently exempt out-out situations. See 1984 Treasury Report, 77. In contrast, the ABA Tax Section VAT Committee Report (at pages 24–25, 76, and 110–114) exempts out-out situations involving a consideration below a threshold amount (to be specified) and gives rise to a revived credit for other out-out situations.

188. See the discussion in the sections titled “The Credit” and “Capital Goods” in chapter 1 and “Changed Use,” “Leases and Deferred Payment Sales,” and “Used Property” in chapter 4.

189. An alternative approach under the federal income tax is to ignore the denied or recaptured credit (the “ignore” approach). Thus, a denied or recaptured credit would be neither deductible nor capitalizable. Subsequent VAT allowance of an unused VAT credit (previously denied or recaptured) would not give rise to taxable income. Although the “ignore” approach is appealing for its simplicity, it is probably not acceptable because it in effect treats the unused VAT credit as a penalty.

A second alternative approach would treat the denied or recaptured VAT credit as an expense, potentially deductible under IRC secs. 162 and 212. However, an unused credit on personal use assets, which is not deductible, would not be capitalized (the “maybe deduct but don’t capitalize” approach). (A variation of this approach would permit a deduction under IRC sec. 164 for all unused VAT credits, subject to general limitations such as those on itemized deductions under IRC sec. 63(b).) Later VAT allowance of an unused VAT credit would give rise to income under the tax benefit rule. The “maybe deduct but don’t capitalize” approach is more complicated than the “ignore” approach but is more equitable. Nevertheless, it is probably not acceptable because in many cases it grants an immediate deduction for a capitalizable cost.

190. An alternative would be to reduce the VAT credit by an amount representing the approximate federal income tax benefit and not to require an income inclusion under the federal income tax.

191. Alternatively, a deferred credit could be treated as a denied credit. (See the paragraph accompanying notes 189 and 190.) This approach is not satisfactory because it would give rise to substantial complexity when the deferred credit is allowed by the VAT and the tax benefit rule must be applied.

192. To the extent that this credit is capitalized as the cost of an asset placed in service in an earlier year, future depreciation alone could reflect the increased cost. Alternatively, an appropriate part of the capitalized cost could be attributed to prior years and either be deducted in the year of VAT denial or give rise to deductions in the years in which the asset was used (requiring the filing of amended income tax returns or a procedure comparable to the procedure of IRC sec. 1341).

193. The U.K. persons surveyed (note 2) were asked about the perception of the general public toward the U.K. VAT. They agreed (1) that the U.K. VAT is perceived by the general public to be fair, insofar as there is a perception (61 percent, 50 percent), (2) that the U.K. VAT is perceived by the general public to be more fair than the U.K. income tax (62 percent, 39 percent), and (3) that requiring retail sales to be stated VAT-inclusive effectively hides the VAT from the general public (63 percent, 57 percent).

194. Other matters of concern include the treatment of bad debts (discussed in chapter 1 in the section titled “Cash Flow Effects of the VAT”) and the treatment of employee purchases of items relating to a trade (discussed in chapter 1 in the section titled “Exemption”). The U.K. persons surveyed (note 2) were asked if the U.K. VAT operates unfairly in three areas. They agreed that it operates unfairly as to bad debts (81 percent, 65 percent) (see paragraph accompanying note 33) but differed over whether it operates unfairly either (1) as to substantial purchases by an employee of assets or services to be used in his or her employment (see notes 61–63 and accompanying text) or (2) as to substantial purchases by a nonregistered, nonretail business of taxable assets or services to be used in the business (see notes 47–48 and accompanying text).

Imposition of the VAT on charities (through the denial of purchase VAT under their exempt status) could also be an area of concern, as could a high registration threshold with no procedure for voluntary registration.


196. As to the major zero-rated groups previously identified (note 20 above), the U.K. persons
surveyed (note 2) agreed or disagreed that each group substantially promotes progressivity in the U.K. VAT, as follows: food (agreed 90 percent, 61 percent); sewerage services and water (agreed 69 percent, 39 percent); books, magazines, and other printed matter (agreed 58 percent, 33 percent); fuel and power (agreed 87 percent, 57 percent); buildings and civil engineering works (agreed 60 percent, 33 percent); and exports (disagreed 70 percent, 41 percent).

As to the major exempted groups previously identified (note 45 above), the U.K. persons surveyed (note 2) agreed or disagreed that each group substantially promotes progressivity in the U.K. VAT, as follows: land (disagreed 63 percent, 33 percent), insurance (disagreed 62 percent, 35 percent), postal services (generally differed), finance (disagreed 68 percent, 37 percent), education (agreed 74 percent, 37 percent), and health and welfare (agreed 79 percent, 41 percent).

When questioned about alternatives to zero rating and exemption to promote progressivity, the U.K. persons surveyed (70 percent, 41 percent—note 2) disagree that progressivity can better be promoted by giving an imputed credit to the taxpayer for wages paid (and for self-employment income) up to a certain level per employee (and self-employed). They agreed, however (77 percent, 59 percent), that the welfare system and not the tax system should be used. The reason given for this stance as to zero rating was usually that zero rating complicates the VAT and is also not efficient as a “subsidy” for low-income persons. That is, zero rating not only “subsidizes” the rich but also, for example, generally provides in absolute terms a larger subsidy for a rich family than for a poor family, because the former spends more on necessities than does the latter.

197. See note 12 above.
198. The seller, however, may have had a competitive advantage arising from a failure to collect taxes or from a collection at too low a rate.
199. The seller, however, may have been at a competitive disadvantage by reason of collecting excessive VAT from customers.
200. Section 24(3) of the U.K. Finance Bill of 1989 would not permit recovery of a mistaken overpayment of VAT if C&E is able to establish that “repayment . . . would unjustly enrich the claimant.”