

Value Added Tax – A (Simple!?) Explanation

VAT is a tax on consumption, ie; the more you buy – the more tax you pay. It is also a neutral tax on businesses, in that it is not intended to represent a real cost to anyone but the end consumer, however, this is not always the result!

Everybody pays VAT to the Government whenever they purchase certain goods or services. This tax is collected for the Government by the supplier of those goods and services. (In the UK this was one of the major differences between VAT and income tax – VAT was collected and calculated by the taxpayer. However with the introduction of self-assessment the two become much more alike).

History

VAT was first devised by a German economist during the 18th century. He envisioned a sales tax on goods that did not affect the cost of manufacture or distribution but was collected on the final price charged to the consumer. Thus it did not matter how many transactions the goods went through, the tax was always a fixed percentage of the final price. (A sales tax is imposed as a percentage of every sale. Therefore if there are three transactions before the goods reach the consumer the total tax is 6% 6% 6% but if there are 5 it is 6% 6% 6% 6% 6%). In this respect, VAT is far fairer than a sales tax.

The tax was finally adopted by France in 1954. Upon the formation of the Common Market it was decided that one requirement of joining was the imposition of a form of VAT. In 1973 the UK joined the EC and replaced the existing Sales Tax with VAT.

It was introduced in the UK with the comment that “VAT is a simple tax.....”!

Who writes the rules?

In order that the countries of the EC implement similar rules for VAT, the form the tax should take is governed by EC legislation. Whilst this legislation has no direct effect in any country, all Member States must draw up local legislation enacting the provisions of the 6th Directive. However, if the local laws should differ from the intent of the 6th directive, taxpayers can insist that the intent is applied and can ultimately take a case to the ECJ.

Most VAT systems implemented by non-European countries are based to varying degrees on the EC 6th directive.

How does it work?

The answer to this is best displayed using an example.

A farmer produces wool required to make a product. He would sell this to the manufacturer. For this wool he may charge £100,000 plus VAT. The VAT on this (in the UK) would be £20,000. The manufacturer would therefore pay the farmer £120,000. Of this amount the farmer would pay to the Government (HMRC) £20,000 and retain £100,000.

The manufacturer can reclaim from the HMRC £20,000 so the wool only costs £100,000. He uses the wool to make socks He would then sell a box of socks to a shop for £100 plus VAT of £20. The £20 is paid over to HMRC.

The retailer claims the £20 from HMRC and sells a pack of socks for £10 plus VAT of £2. The £2 is paid to HMRC.

Consequently, the end consumer pays £12 for the socks of which £2 is VAT. He is not entitled to reclaim this amount and HMRC gets to keep the cash. At this point the VAT is known as “sticking tax”.

So why is it so difficult?

All looks quite simple doesn't it? Well there's the rub. When the VAT system was devised, some goods and services were thought to be so important that you should pay less tax (or none) on them. This was done in two ways: zero rating and exemption.

Zero Rating: The retailer charges the consumer VAT at a rate of 0%. The retailer can reclaim any VAT it is charged and the goods are therefore not taxed at any time. The UK is the only Member State to apply a zero rate and this special treatment is guarded ferociously against the EC by politicians.

Exemption: The retailer charges no tax on the goods or services. However the retailer is not generally entitled to reclaim any VAT it incurs. Tax is therefore collected one step up the chain on a lesser amount (it does not include the mark up made by the retailer). Exemption is always a burden on a business and not a relief, the relief applies to the end user only.

And.....?

As with all legislation, VAT law cannot keep up with the changes in society and specifically; technology and must therefore be constantly interpreted to apply to current situations.

For example the infamous UK Jaffa Cake case. Biscuits and cakes are considered a necessity by UK law and are zero rated. Chocolate covered biscuits however are a luxury and subject to VAT at 17.5%. McVities and HM Customs & Excise (as HMRC was known then) argued over whether the Jaffa Cake was a cake (no VAT) or a chocolate biscuit (lots of VAT). The argument had to be taken to a court to be resolved. In the end McVities baked a 12" Jaffa Cake and a giant model which convinced the Tribunal Chairman of the general cakeiness of the Jaffa Cake! On such small things massive amounts of tax turn!

So is VAT really all that difficult?

Well, I shall leave the last word to the Tribunal Chairman in the Royal Sun Alliance case who observed that 'Beyond the everyday world, lies the world of VAT, a kind of fiscal theme park in which factual and legal realities are suspended or inverted!'