

VAT definitions in Europe

VAT was invented by Maurice Lauré a French economist in 1954 as *taxe sur la valeur ajoutée*. And the French tax authority, the *Direction générale des impôts*, was first to introduce VAT for large businesses, and it was extended over time to all business sectors.

What is VAT?

Value added tax VAT is a general tax which affects nearly all **consumption of goods and services**. Businesses engaged in the commercial sale of goods and services are taxable persons. However, since **VAT is a consumer tax**, it is not intended to burden the taxable persons and is instead transferred to the final consumer prices.

Value added tax is

- a **general tax** that applies, in principle, to all commercial activities involving the production and distribution of goods and the provision of services.
- a **consumption tax** because it is borne ultimately by the final consumer. It is not a charge on businesses.
- charged as a percentage of price, which means that the actual tax burden is visible at each stage in the production and distribution chain.
- collected **fractionally**, via a system of partial payments whereby taxable persons (i.e., VAT-registered businesses) deduct from the VAT they have collected the amount of tax they have paid to other taxable persons on

purchases for their business activities. This mechanism ensures that the tax is **neutral** regardless of how many transactions are involved.

- paid **to** the revenue authorities by the seller of the goods, who is the "taxable person", but it is actually paid **by** the buyer to the seller as part of the price. It is thus an indirect tax.

By definition, the value added tax levied at each stage in the economic chain of supply **is a constant fraction of the value added by a business** to products and/or services. Businesses collect the tax on their sales, then pay it to the state.

Businesses pay VAT on their purchases, and in most cases they are entitled to deduct that VAT.

Personal end-consumers of products and services cannot recover VAT on purchases, but businesses get reimbursement of most of VAT on the materials and services that they buy to make further supplies or services directly or indirectly sold to end-users.

VAT that is charged by a business and paid by its customers is known as *output VAT* (that is, VAT on its output supplies).

VAT that is paid by a business to other businesses on the supplies that it receives is known as *input VAT* (that is, VAT on its input supplies). A business is generally able to recover input VAT to the extent that the input VAT is attributable to (that is, used to make) its taxable outputs. Input VAT is recovered by setting it against the *output VAT* for which the business is required to account to the government, or, if there is an excess, by claiming a repayment from the government.

How is VAT charged?

The VAT due on any sale is a percentage of the sale price but from this the taxable person is entitled to deduct all the tax already paid at the preceding stage. Therefore, double taxation is avoided and tax is paid only on the value added at each stage of production and distribution. In this way, as the final price of the product is equal to the sum of the values added at each preceding stage, the final VAT paid is made up of the sum of the VAT paid at each stage.

Company A sells 100 electronic components to Company B

1000 euros + VAT 25% = 1250 euros

Company B will pay the invoice for components to company A

Company A pays **250 euros** to the TAX Office.

Company B manufactures computers and sells them to consumers. The price of the components are included in the price of a computer

a computer is sold 2500 euros (including VAT 500 euros).

Company B will declare 500 euros as output VAT minus 250 euros as input VAT (charged by company A)

and pay **250 euros** to the Tax Office.

The total of VAT paid to the Tax Office is **500 euros**.

Output and input VAT and VAT payments to the Tax Office are done according to the local rules of the country where the taxable person is VAT registered.

VAT returns are done electronically or with special forms like the exemple shown to the left (Swedish VAT return).

Businesses that conduct commercial activities and sell goods or services liable to VAT **must register** with the Tax Agency. They must also submit tax returns and pay VAT to the Tax Agency. They must pay the difference between the VAT that they charge on their sales and the VAT that they pay on their purchases. If they import goods from countries outside the European Union, they must pay VAT to the Customs.

How do the Member States apply VAT?

The detailed application of VAT varies according to the administrative customs and practices of each member state within the framework set out by Community legislation

A **common VAT system** is compulsory for member states of the **European Union**.

The EU VAT system is imposed by European Union Directives, currently Directive 2006/112/EC which is a recast of the Sixth Directive of 1977. The Directives are Laws. VAT is compulsory. VAT has been created in order to match the basic requirements of fair and equal competition in the

European Community. If there was ever going to be an efficient, single market in Europe, a neutral and transparent turnover tax system was required which ensured tax neutrality.

Currently, there is a standard rate of between 15% and 25% (the maximum is based on a political commitment) and Member States may apply 1 or 2 reduced rates of at least 5%. There are a number of temporary derogations. The VAT coverage also still differs from one Member State to another.

Should every businesses charge VAT ?

The Swedish Tax Office uses the VAT Cat (mervärdessKATTEN) to illustrate VAT liability in Sweden

All four conditions below must be fulfilled for you to be liable to charge VAT to your customer.

- You **turn over** (sell or self-supply) goods or services
- The goods or services are **liable to VAT**
- Turnover takes place as part of **commercial activities**, and
- Turnover takes place **in Sweden**.

The conditions can be illustrated using the "VAT Cat". The cat must stand on all four legs to meet the VAT liability requirements, i.e. be obliged to charge its customers VAT.

- first leg : **turn over**
- second leg : **VAT liability** (of the goods and services)
- third leg: **commercial activity**
- fourth leg: the **place of supplying** (here: Sweden)



What is a taxable person?

For VAT purposes, a taxable person is any individual, partnership, company or whatever which supplies taxable goods and services in the course of business.

Any organisation, individual, company with taxable supplies must register for VAT. Registered VAT traders are given a number and have to show the VAT charged to customers on invoices. In this way, the customer, if he is a registered trader, knows how much he can deduct in turn and the consumer knows how much tax he has paid on the final product. In this way the correct VAT is paid in

stages and to a degree the system is self-policing.

Particular rules

VAT registration is the general rule but there are exceptions for businesses whose annual turnover is less than a certain limit (the threshold), which differs according to the Member State. These persons do not have to charge VAT on their sales.

Besides, some businesses have to register for VAT in several European countries in case for example of supply of certain services or sales of goods to consumers over local thresholds.

Abbreviations and terms

Acquisition = purchase

Asset item = asset intended for permanent use in the business.

Business accessories = equipment or interior fittings in a property acquired for direct use in a particular business.

Current asset = asset intended for sale.

EC = area within the European Community VAT area.

Electronic service = service supplied electronically, often via Internet.

EU = European Union

Export = sale of goods to a place outside the EC or sale services outside the EC.

Foreign trader = A business that does not have its registered office or fixed place of establishment in the country and that is not permanently here.

Goods = material things such as raw materials, semi finished and finished consumer or capital goods and property. Also included are gas, heating and cooling, and electricity.

Import = goods brought into a European country from a place outside the EC.

Input VAT = VAT that enterprises pay on business purchases.

Intra-Community acquisition = Purchase of goods from another EC country when the purchaser pays VAT in one of the European countries.

Mixed business = sales exempt from VAT and liable to VAT.

Output VAT = VAT that enterprises charge to their customers and pay to the state.

Profit Margin Taxation (PMT) = method of taxation on difference between purchase price and sale price.

Reverse VAT liability = liability to report and pay VAT transferred to purchaser.

Right of deduction = right to deduct input VAT or obtain a VAT refund on purchases or imports for activities liable to VAT.

Self-supply = you supply goods or services without payment, e.g. for private use.

Service = something that can be sold other than goods, e.g. a right.

Split financial year = financial year other than the calendar year.

Tax rate = percentage rate for calculation of output VAT (tax rate x taxable basis = VAT).

Tax year = generally the financial year.

Taxable basis = the value on which VAT is calculated.

Taxable entity = entity that must pay VAT to the state.

Turnover = sale or self-supply.

VAT return = return for VAT

VAT registration number = number given to entities registered for VAT by the Tax Agency.

VAT Services for European and non-European companies - distance selling of goods and services.

We act for VAT representation in Sweden in case of distance selling of goods and services.

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