Value Added Tax Overview

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Department of Revenue

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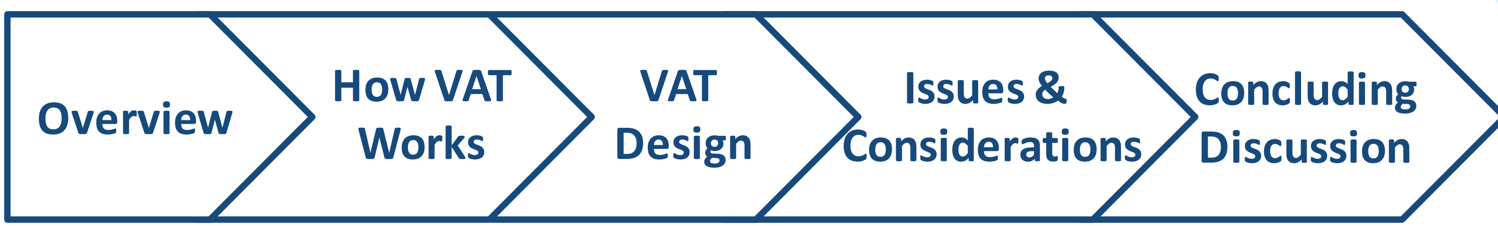
Presentation Preview



Overview

Understanding Value Added Tax

- A value add tax (VAT) is a tax that is imposed on sellers on the value of products created at each stage throughout the product chain
- A business's value added is the difference between revenues generated from its sales to customers and the price of inputs purchased from other businesses

Overview

Tax on the Returns on Labor and Capital

A business's two key inputs are labor and capital

Businesses organize and utilize labor and capital to create goods and services of greater value than the original cost of purchased capital inputs

The value created by the business is divided between:

- The return on labor (wages)
- The return on capital (profits, interest paid, reinvested capital)

How Value Added Tax Works

	Fisher	Manufacturer	Wholesaler	Retailer	Consumer	Total
Sales (before VAT)	$200	$600	$700	$900	-	
Purchases	-	$200	$600	$700	$900	
Value Added	$200	$400	$100	$200	-	$900

How Value Added Tax Works

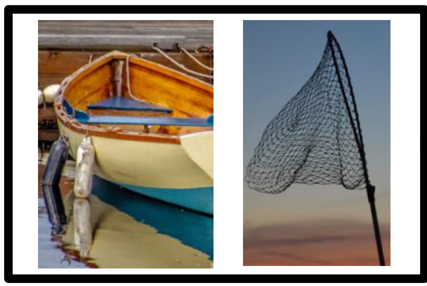
	Fisher	Manufacturer	Wholesaler	Retailer	Consumer	Total
Sales (before VAT)	$200	$600	$700	$900	-	
Purchases	-	$200	$600	$700	$900 + $90 VAT	
Value Added	$200	$400	$100	$200	-	$900
10% VAT	**$20**	**$40**	**$10**	**$20**	**-**	**$90**

How Value Added Tax Works

Fisher

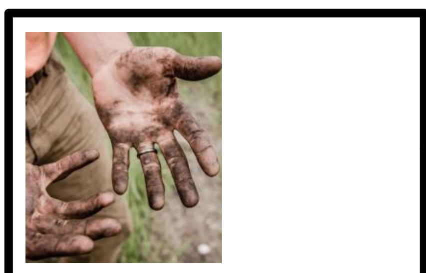
Sales: $200
Cost of Goods Sold: $0
Gross Profit: $200
Deductible Operating Expenses: $0
Value Added: $200

Capital: $0

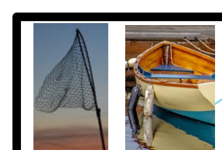


Output: $200

Labor



Sole Prop Income: $200



How Value Added Tax Works

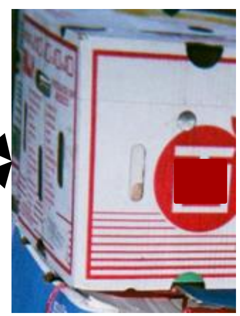
Manufacturer

Sales:	$600
Cost of Goods Sold:	$100
Gross Profit:	$500
Deductible Operating Expenses:	$100
Value Added:	$400

Capital: $200

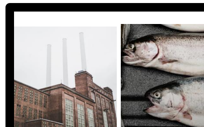
Labor

Output: $600



Loan Interest: $50

Profit (Dividends): $150



Wages: $150

Benefits: $50

How Value Added Tax Works

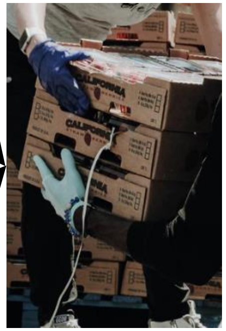
Wholesaler

Sales:	$700
Cost of Goods Sold:	$400
Gross Profit:	$300
Deductible Operating Expenses:	$200
Value Added:	$100

Capital: $600

Labor

Output: $700



Depreciable Assets (CAPEX): $50

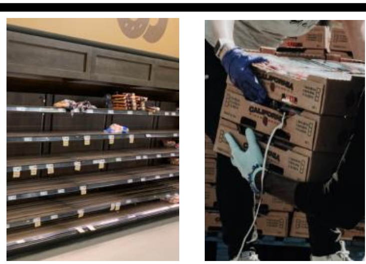
Wages: $50

How Value Added Tax Works

Retailer

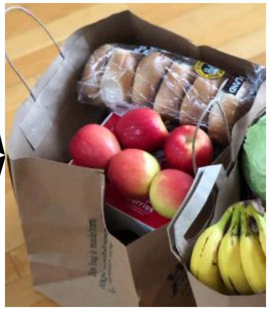
Sales:	$900
Cost of Goods Sold:	$600
Gross Profit:	$300
Change in Inventory:	$50
Deductible Operating Expenses:	$50
Value Added:	$200

Capital: $700



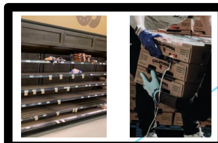
Labor

Output: $900



Loan Interest: $100

Partnership Profit: -$100



Wages: $200

How Value Added Tax Works

Comparison of Tax Bases

					TAX BASES			
Business	Capital Purchases	Sales	Profits, Interest, CAPEX	Wages, Comp.	Gross Receipts Tax	Retail Sales Tax	Corp/ Net Receipt Tax*	VAT
Fisher	-	$200	-	$200	$200	-	-	$200
Manufacturer	$200	$600	$200	$200	$600	-	$138	$400
Wholesaler	$600	$700	$50	$50	$700	-	$36	$100
Retailer	$700	$900	-	$200	$900	$900	-	$200
Total	**$1,500**	**$2,400**	**$250**	**$650**	**$2,400**	**$900**	**$174**	**$900**

*As a sole proprietor, fisher faces no corporate income/net receipts tax
*Assumes deductible depreciation equals 2% of Sales
*Assumes interest is 100% deductible

How Value Added Tax Works

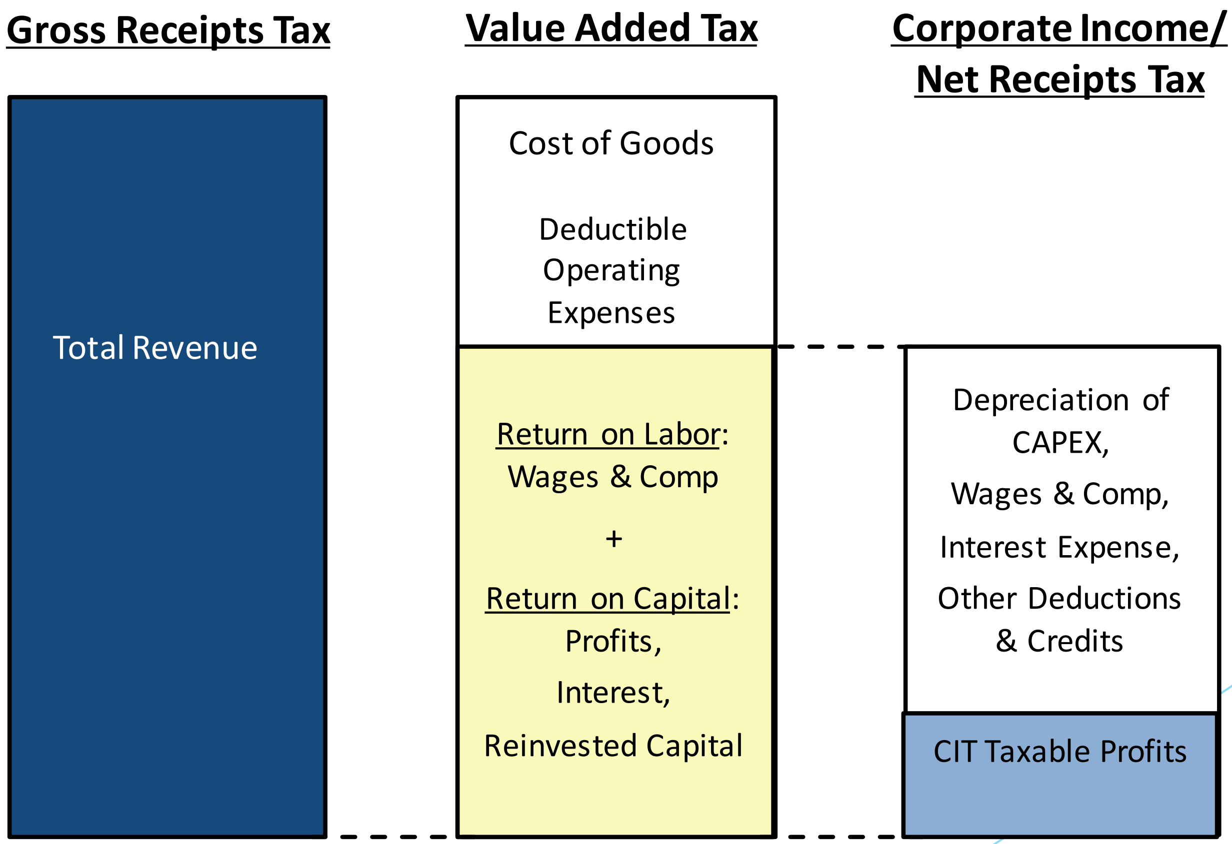
Comparison of Tax Bases

					TAX BASES			
Business	Capital Purchases	Sales	Profits, Interest, CAPEX	Wages, Comp.	Gross Receipts Tax	Retail Sales Tax	Corp/ Net Receipt Tax*	VAT
Fisher	-	8%	-	31%	8%	-	-	22%
Manufacturer	13%	25%	80%	31%	25%	-	79%	44%
Wholesaler	40%	29%	20%	8%	29%	-	21%	11%
Retailer	47%	38%	-	31%	38%	100%	-	22%
Total	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

*As a sole proprietor, fisher faces corporate income/net receipts tax
*Assumes deductible depreciation equals 2% of Sales
*Assumes interest is 100% deductible

How Value Added Tax Works

Comparison of Tax Bases



How Value Added Tax Works

Initial Takeaways

Although the form of the VAT has the appearance of a business tax, a broad, destination-based VAT is considered a consumption tax, borne by consumers

In theory, such a VAT and a similarly broad-based Retail Sales Tax (RST) have very similar tax bases

(In practice, there are some differences between a VAT and RST tax base)

The VAT does not suffer from the tax pyramiding effect of a gross receipts tax, where downstream businesses pay tax on value that was added by businesses upstream in the product chain

VAT Design

Credit-Invoice Method vs. Subtraction Method

Credit-Invoice Method	Subtraction Method
• By far the most common form of VAT • Transactional • Businesses subject to VAT register • Sales are taxed at each stage of production • Sellers provide buyers with a VAT invoice • Buyers (except final consumer) can claim a credit on VAT paid by suppliers • Sales to out-of-state customers exempt	• Most prominent recent example is Japan • Based on annual/periodic accounts • Businesses are taxed on the difference between non-exempt sales and non-exempt purchases in the period • Taxing jurisdictions may encourage/ require VAT invoicing • Apportionment of in-state vs. out-of-state sales/purchases

VAT Design

Credit-Invoice Method vs. Subtraction Method

Credit-Invoice Method	Subtraction Method
• Audit trail	• Lower compliance cost (taxpayers)
• Higher voluntary compliance	• Lower administrative cost (state)
• Relatively more attractive if VAT tax rate is high	• Relatively more attractive if VAT tax rate is low

Issues & Considerations

Cross-Border Transactions
The subtraction method VAT may be destination-based or origin-based, depending on apportionment
Based on current Washington tax structure, we assume that VAT apportionment would be based on in-state vs. out-of-state sales ratio (i.e., destination based)

Issues & Considerations

Cross-Border Transactions: Destination-based VAT

Seller 1		Consumer	Total Price to Consumer
WA	100 + 10 VAT	**WA**	**110**
OR	100 + 10 VAT	**WA**	**110**
WA	100	**OR**	**100**

Issues & Considerations

Cross-Border Transactions: Destination-based VAT

Seller 1		Seller 2		Consumer	Total Price to Consumer
WA	100 + 10 VAT	**WA**	100 + 10 VAT	**WA**	**220**
OR	100	**OR**	100 + 10 VAT	**WA**	**210**
WA	100 + 10 VAT	**WA**	100	**OR**	**210**

Issues & Considerations

Cross-Border Transactions: Destination-based VAT, Tracking State of Purchase

Seller 1		Seller 2		Consumer	Total Price to Consumer
WA	100 + 10 VAT	**WA**	100 + 10 VAT	**WA**	**220**
OR	100	**OR**	100 + 20 VAT	**WA**	**220**
WA	100 + 10 VAT	**WA**	100 - 10 VAT	**OR**	**200**

Issues & Considerations

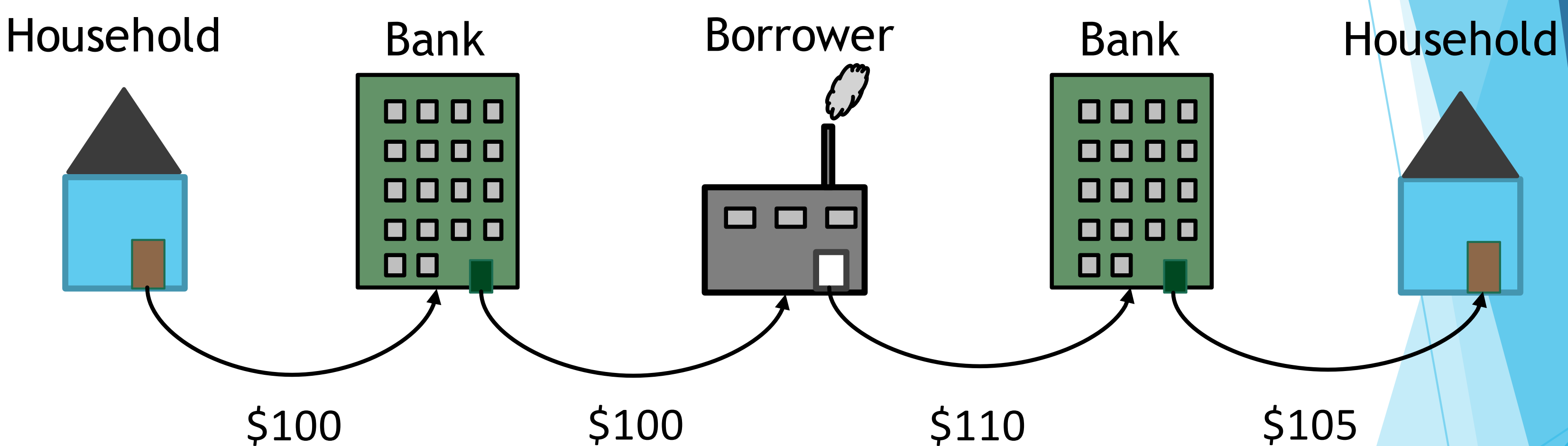
Depreciable Assets
Capital expenditures on assets that are depreciable over more than one year are not deductible under the proposed VAT
In this way, VAT cannot be avoided by “reinvesting profits”
However, Gates (2002) suggested deductions for capital expenditures or depreciation as a potential mechanism to increase competitiveness of Washington businesses

Issues & Considerations

Exemptions
Gates (2002) did not propose exemptions on specific entities/activities, but did not rule out limited exemptions
In practice, all existing VATs exempt certain activities
Common exemptions include: • Medical services • Social services • Government • Education • Real estate • Financial services

Issues & Considerations

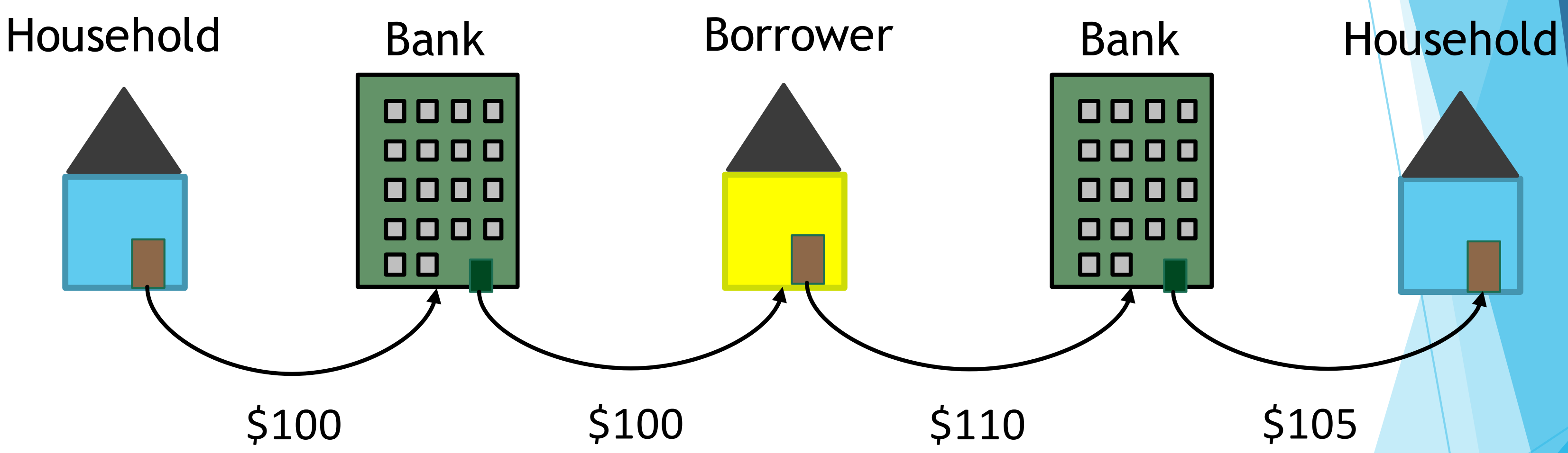
Financial Services: Banking & Lending



- The borrower paid VAT on its value added, with no interest deduction
- Thus, taxing the bank may lead to double taxation

Issues & Considerations

Financial Services: Banking & Lending



- If borrower is another household, exempting bank from VAT leaves some value added untaxed
- What portion of financial services companies' returns relate to: 1) Investment income, 2) Time value of money, 3) Inflation, 4) Hedging/risk mitigation, 5) Other services

Questions for us?

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