A brief introduction to VAT in the European Union
Understanding VAT - Value Added Tax - in the European Union

Value added tax (VAT) is a sales tax levied on the supply of goods and services. In some countries, this tax is known as “goods and services tax” or GST. VAT is an indirect tax, meaning that the tax is collected from someone other than the entity who bears the cost of the tax.

VAT applies more or less to all goods and services that are bought and sold for use or consumption in the European Union (EU). Goods and services supplied for export to customers outside the VAT area are not normally subject to VAT. Conversely importations are taxed to maintain a balance for domestic producers so that they can compete on equal terms within the European market with imports from outside the EU.

A common VAT system is compulsory for all member states of the EU. When a person or business is carrying out any economic activity supplying goods and services to other entities and the value of the supplies passes a certain financial threshold, the supplier is required to register with the local taxation authorities and charge its customers VAT.

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

End-users like private consumers of products and services cannot recover input VAT on purchases, but businesses registered for VAT are able to recover input VAT on the goods and services that they buy to make further supplies or services directly or indirectly sold to end-users. In this way, the total tax levied at each stage in the economic chain of supply is a constant fraction of the value added by a business to its products, and most of the cost of collecting the tax is borne by businesses, rather than by the state. Please see figure 1 for an example of the VAT chain.

Figure 1: The VAT chain
Example showing how VAT works

<table>
<thead>
<tr>
<th>Transaction flow</th>
<th>Transaction 1 Company A is selling to Company B</th>
<th>Transaction 2 Company B is selling to Company C</th>
<th>Transaction 3 Company C is selling to private individual</th>
<th>Transaction 4 Bought by private individual</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type of transaction</td>
<td>Buy</td>
<td>Sell</td>
<td>Buy</td>
<td>Sell</td>
</tr>
<tr>
<td>Price excluding VAT</td>
<td>500</td>
<td>1,000</td>
<td>1,000</td>
<td>1,250</td>
</tr>
<tr>
<td>20% VAT calculated</td>
<td>100</td>
<td>200</td>
<td>200</td>
<td>250</td>
</tr>
<tr>
<td>Price including VAT</td>
<td>600</td>
<td>1,200</td>
<td>1,200</td>
<td>1,500</td>
</tr>
<tr>
<td>VAT collected through value-added transactions</td>
<td>100</td>
<td></td>
<td>50</td>
<td></td>
</tr>
<tr>
<td>Comments</td>
<td>A has collected 200 for the state but is reclaiming 100 for the purchase and will send net 100 to the state</td>
<td>B has collected 250 for the state but is reclaiming 200 for the purchase and will send net 50 to the state</td>
<td>C has collected 350 for the state but is reclaiming 250 for the purchase and will send net 100 to the state</td>
<td>Private buyer cannot reclaim any VAT for the purchase and must sell without adding VAT</td>
</tr>
</tbody>
</table>

Public bodies, state institutions, banks, unions, clubs and selected industries cannot register for VAT and must bear the burden of the input VAT without being able to recover it but have the advantage in that they are not obliged to collect any output VAT from its customers. Any business not registered for VAT will normally be treated as described above.

If businesses registered for VAT in different EU member states are conducting a transaction, this will be made based on a so-called intra-Community acquisition, which is based upon strict invoicing and reporting rules. The seller will not add local output VAT to their invoice but will report the transaction to their local VAT authority as a sale to another EU member state. The buyer will also report the purchase to their local VAT authority and calculate and immediately recover the input VAT based at the home rate. The transaction is only a paper exercise but is important to keep the EU VAT system intact and to avoid the necessity for EU established businesses will have to recover output VAT in across 27 different EU member states.

Any transaction made not using the intra-Community acquisition system will include payment of the local VAT and it is up to the buyer to recover any VAT from each respective EU member state.
The minimum standard rate of VAT throughout the EU is 15%, although reduced rates of VAT, as low as 5%, are applied in various member states on certain goods and services. The maximum rate of VAT in the EU is 27%. The ultimate purpose of the EU is to create a single market place covering all EU member states through harmonization of local rules and the long-term plan is obviously to have one uniform VAT rate for all EU member states.

The EU VAT system has many exceptions. Some exceptions are accepted by the EU commission prior to the entry of a new member state in the EU. Others have just “silently” lived on even though they conflict with EU VAT directives and these are often terminated when discovered by the EU Commission. The 0% VAT exceptions for aircraft in Denmark and the United Kingdom, which were terminated in 2010, were never accepted prior to the accession of those states into the EU. Thus, these exceptions were terminated due to harmonization request from the EU Commission when “discovered” in 2009 due to the “Cimber” court case despite having existed since 1967.

Most EU member states’ revenue authorities have always had a particular focus on means of transportation such as yachts, cars, trucks, trains and aircraft as they have a high value and easily move around. The main objective of each member state is of course to secure the correct VAT payment on high value assets if used in the EU.

All international airlines (including AOC or charter certificate holders) are still VAT exempt meaning that any supplier (even though registered for VAT) can invoice the airline with 0% output VAT and the airline is also allowed to import their aircraft at the same 0% rate. However, each EU member state has their own standards qualifying an airline as an “international airline” and therefore eligible for the VAT exemption. Any other business entity will have to account for the VAT at its local VAT rate in the country in which they are registered.

If you have any questions or comments, please do email me directly: lr@opmas.dk

Best regards
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