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**The Right of Deduction within the European VAT:
A Perspective for the VAT Reform in China**

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Abstract

Value added tax (VAT), with its specific and unique feature as a neutral taxation, has spread rapidly around the world since its first adoption in Europe. China has also chosen to adopt VAT in an attempt to promote its economic development. In 2012, China started a new round of reform of VAT to extend its scope to industries which previously were liable to business tax. One of the most difficult problems is the rebuilding of the VAT deduction system therein. Although Europe faces its own problems and difficulties in the process of perfection and coordination of VAT, as the cradle of VAT it could still provide helpful insights for the ongoing VAT reform in China. Based on the analysis of the VAT system and, in particular, the right to deduct input VAT in Europe, combined with the development and special conditions of VAT in China, I propose several recommendations for the ongoing VAT reform in China and its future legislation. First, on the overall level, it is important to review the principle of neutrality in VAT, and rather than to view it as a natural result of the operation of the VAT system, its role as a rule to be complied with. Second, with regard to the design of the VAT deduction system, I argue that: (1) it is not necessary to establish VAT deduction as a substantive right of the taxpayer; (2) it is necessary to expand the scope of deductible items in China, especially in relation to fixed capital investment; (3) it is urgent to improve the treatment of the excess amount of deductible input VAT. Finally, suggestions are given supporting the construction of the related procedural legislation.

Key Words: Value-added Tax system, VAT Deduction, Right of Deduction, European VAT Directive, European Internal Market, Chinese VAT Reform, VAT Legislation

Contents

Abstract.....	I
Chapter 1 Value Added Tax in the European Union.....	1
Section I An overview of the legislation system of European VAT.....	1
1. Institutions of the EU.....	1
1.1 The legislative branch.....	1
1.2 The juridical branch.....	4
2. Legal instruments of the EU.....	10
2.1 Directly applicable in its entirety.....	10
2.2 Instruments with restricted binding effect.....	11
2.3 No binding effects.....	12
2.4 The effect of European law.....	13
3. The EU VAT legislative system.....	13
3.1 The legal instrument applied in EU VAT.....	14
3.2 The procedures involved.....	15
Section II The harmonization of EU VAT in the context of the internal market.....	17
1. The legal source for harmonization.....	17
2. Definition of terms.....	18
2.1 The legal character of EU VAT.....	18
2.2 “Harmonization” in the context of the EU.....	21
2.3 The internal market.....	22
2.4 The interaction between “harmonization” and the “internal market”.....	24
3. The process of harmonization of EU VAT.....	26
3.1 Historical overview of the harmonization process.....	26

3.2 Harmonization of the right of deduction in EU VAT.....	29
Chapter 2 The right of deduction and its exercise in Europe.....	33
Section I The right of deduction.....	33
1. Circumscription of the right to deduct input VAT.....	33
1.1 The right to deduct input VAT in the credit invoice method VAT.....	33
1.2 Deduction – the “right” that makes a taxpayer a “creditor”.....	36
1.3 The relationship between deduction and refund in a VAT system.....	41
2. Characteristics of the right to deduct input VAT.....	44
2.1 Immediacy.....	44
2.2 Integrity.....	46
3. Prerequisites for the right of deduction.....	48
3.1 Substantial element: the related goods or services relate to taxable economic actions (taxable transactions) by the taxable person.....	48
3.2 Formal element: the issue of an invoice.....	55
3.3 The time element.....	62
Section II The exercise of the right of deduction.....	64
1. The triangular relationship between the “protagonists” in the exercise of the right of deduction.....	64
2. The general principles — effectiveness and neutrality — in the exercise of the right of deduction.....	65
2.1 What is the principle of neutrality?.....	66
2.2 The right of deduction in VAT and the principle of neutrality.....	74
3. Regulations set by the case law of the ECJ to exercise the right of deduction.....	76
3.1 The immediate and direct link.....	76
3.2 The substantial element outweighs the formal element (substance over form).88	

4. Restrictions to the right of deduction in VAT.....	99
4.1 Non-deductibility of non-business expense.....	100
4.2 Non-deductibility of business entertainment.....	103
4.3 Restriction of the right of deduction under the exempt condition.....	111
5. The treatment of the excess of the deductible amount.....	118
Chapter 3 Value-Added Tax in China.....	123
1. Historical overview of VAT in China.....	123
1.1 The brief but changeable history of VAT in China.....	123
1.2 The historical development trends of VAT in China and its future directions	127
2. The ongoing reform to expand the scope of VAT.....	129
2.1 The background of the reform.....	129
2.2 The detailed processes of the reform.....	131
2.3 Transitional measures adopted in the ongoing reform.....	134
3. Chinese treatment of VAT deduction in certain situations.....	139
3.1 VAT deduction in the situation where a taxpayer acquires “ falsely issued ” invoices.....	139
3.2 VAT deduction of preparatory activities.....	154
4. The current difficulties faced in the Chinese VAT system.....	156
4.1 From a general perspective.....	156
4.2 Specific problems for VAT deduction.....	157
Chapter 4 Future direction for Chinese VAT and its deduction— from the perspective of Europe	159
Section I The deserved role of VAT in China.....	160
1. The legal characters that ought to be possessed by Chinese VAT.....	160
1.1 Further analysis of the characteristics of VAT in Europe.....	160

1.2 The legal character of VAT in China —from the past to the future.....	163
2. The scope of VAT in China —VAT treatment of the remaining tough sectors.....	166
2.1 Specific challenges faced in VAT reform of financial and insurance services	167
2.2 The efforts made and alternatives discussed in Europe with regard to VAT treatment of financial and insurance services.....	170
2.3 Inspiration for the ongoing VAT reform in China.....	173
SectionII Guiding principle and interest protection in Chinese VAT.....	176
1. The guiding principle to be obeyed for China’s VAT reform.....	176
1.1 The improper interpretation of the principle of neutrality in China.....	177
1.2 Interpretations of the principle of neutrality in Europe.....	182
2. Choice of interest protection to be made by VAT in China.....	187
2.1 General conditions for protection of taxpayers’ rights in China.....	188
2.2 Protection of taxpayers’ rights in China’s VAT —from the perspective of the right to deduct.....	192
2.3 Improvements in protection of taxpayers’ rights in China’s VAT: inspirations from Europe.....	197
Chapter 5 Conclusion —Proposals for Chinese VAT legislation.....	202
1. General remarks.....	202
2. Suggestions on the overall level.....	202
2.1 Being guided by the principle of neutrality.....	203
2.2 Emphasis on protection of taxpayers’ rights.....	204
3. Core mechanism design —the input VAT deduction system.....	206

3.1 Establishment of the right of deduction.....	206
3.2 To Extend the VAT Deductible scope.....	212
3.3 The exercise of VAT deduction.....	215
4. Supporting construction of the related procedural legislation.....	219
4.1 Annual declaration and adjustment system for VAT.....	219
4.2 Protection of taxpayers' rights in the procedural tax law.....	220
Annex 1.....	223
Annex 2.....	223
Reference.....	225

Chapter 1 Value Added Tax in the European Union

Section I An overview of the legislation system of European VAT

European VAT here refers to the value-added tax (VAT) applied and developed in the context of the European Union which is endeavoring to establish a single market.

1. Institutions of the EU

The establishment of the European Union (EU)¹ is undoubtedly a magnificent feat in human history. Most remarkable is its operating mechanism which ensures the EU operates in an orderly manner. Briefly, the European institutions can be divided into three branches according to their respective roles, namely, the legislative branch, the executive branch and the juridical branch. With regard to the subject being discussed in this part, the focus is on the legislative and juridical branches.

1.1 The legislative branch

Like any country, the EU has its own institutions and procedures for legislation. The main legislative procedure adopted is called “the ordinary legislative procedure”², which was introduced with the Maastricht Treaty as the “co-decision procedure”. In this procedure, three institutions are mainly involved: the European Commission, the European Parliament and the Council of the EU. Its operation is outlined in Article 294 of the Treaty on the Functioning of the EU (TFEU) (formerly Article 251 TEC pre-Lisbon Treaty). Under this procedure, the Commission presents a proposal to the Parliament and the Council. Then comes the “co-decision process”, meaning that the Council and Parliament jointly consider law proposals from the Commission. The basis for the procedure is that these three institutions not only play different roles in the EU but also represent the interests of different parties.

¹ The European Union was formally established in 1993 by the Maastricht Treaty. Prior to this, there was the European Coal and Steel Community (ECSC) established in 1952 by the Treaty of Paris, the European Economic Community (EEC) and the European Atomic Energy Community (Euratom) established separately in 1957 by the Treaties of Rome. In 1967, under the Merger Treaty signed in Brussels, the previous two communities (ECSC and EEC) were merged into the European Community.

² There are other special procedures used in sensitive areas which reduce the power of Parliament.

1.1.1 European Commission

First, the European Commission, which actually belongs to the executive branch, takes the role as the executive arm of the EU (much like the “government” of a State) and is responsible for the implementation of EU policy, administering the budget, ensuring compliance with EU law, etc., in addition to submitting proposals for new legislation to the Parliament and to the Council. In spite of the fact that it is composed of one appointee from each Member State (currently twenty-eight), it is designed to be independent of national interests. It could be deduced from the general legislative procedure that the Commission has the right of initiative as only a formal proposal submitted by it can serve as a basis for the co-decision.

In the sphere of VAT, the Advisory Committee on Value Added Tax (hereinafter the VAT Committee) is the relevant body. It was set up under Article 398 of Council Directive 2006/112/EC³ (hereinafter VAT Directive 2006) to promote the uniform application of the provisions of the Directive. According to the content of the provision, the Committee is made up of representatives of Member States, and the Commission provides the chairman and secretariat. As its name implies, VAT Committee is a mere advisory body, which means its guidelines have no legal force; they cannot be invoked in court, neither can it be an obligation for the Member States to apply them. Its main function is to provide a formal forum for consultation where this is required by VAT Directive 2006. The articles in VAT Directive 2006 that are subject to such a consultation procedure are the following:

- Article 11, which allows Member States the option to permit VAT groups;
- Article 27, which permits Member States to treat the self-supply of certain services as taxable supplies;
- Article 155, which allows the Member States to exempt certain transactions relating to international trade;

³ Council Directive 2006/112/EC of November 28, 2006 on the common system of VAT. Formerly Article 29 of the Sixth Directive.

- Article 164, which permits the Member States to exempt transactions with a view to export and in the framework of trade under certain conditions;
- Article 177, which authorizes Member States to exclude capital goods from the right to deduct input tax for cyclical economic reasons;
- Article 191, which allows Member States to refrain from applying the provisions regarding the adjustment of deductions for capital goods;
- Article 238, which permits Member States to take simplification measures of the issuing of VAT invoices under certain situations;
- Article 281, which allows Member States to apply simplified procedures to small undertakings;
- Article 318, which permits Member States to calculate the taxable amount of certain taxable dealers for each tax period in respect of supplies of goods subject to the margin scheme;
- Article 352, which authorizes Member States to tax transactions between taxable persons who are members of a regulated gold bullion market.

In the light of above, and with the fact that VAT Committee acts as a mere advisory body, the current situation of the harmonization of EU VAT is far from the desired one, which will be elaborated later. In fact, VAT Committee now more or less plays the role of legitimizing Member States to derogate from the EU VAT system, but not an actual control body.

1.1.2 European Parliament

Second, the European Parliament: as the only directly elected body in the EU, it represents nearly 500 million citizens. As a result of the Maastricht Treaty, the European Parliament is becoming increasingly influential in the politics of the EU. Over fiscal matters such as VAT, however, it enjoys only limited rights. As in any parliament, the number of MEPs with even a superficial knowledge of such a

technical area as VAT is strictly limited⁴.

1.1.3 The Council of the EU

Last is the Council of the EU (informally known as the Council of Ministers or just the Council), which should not be confused with the European Council⁵. The Council of Ministers is the overall decision-making body with responsibility for the various areas of policy for the EU. The division of the council in charge of fiscal matters is the Economic and Financial Affairs (ECOFIN) council, which plays a crucial role in the legislation of EU VAT. The ministers of the Council represent their governments and are accountable to their national political systems, namely the interests of the respective Member States.

So far, the three institutions in the legislative branch represent respectively the interests of the EU, the citizens and the Member States, and the approval of a certain law is the result of the compromise between these three stakeholders. Thus, the difficulty for a European law to be formally adopted is evident, not to mention a law with respect to economic and financial matters.

1.2 The juridical branch

From a broad perspective, the juridical branch of the EU is the Court of Justice of the EU, which is composed of the following chambers: the Court of Justice (ECJ), the General Court⁶ and the Civil Service Tribunal⁷. The ECJ, the highest court in matters of EU law, plays a crucial role in the implementation of EU law, including its interpretation and its equal application across all EU member states.

⁴ See Adrian Ogle, *Principles of Value Added Tax: a European Perspective*, Interfisc Publishing, 1998, p. 37.

⁵ The European Council is the group of heads of state or government of the EU member states.

⁶ The creation of the General Court instituted a judicial system based on two levels of jurisdiction: all cases heard at first instance by the General Court may be subject to a right of appeal to the Court of Justice on points of law only.

⁷ The EU Civil Service Tribunal was set up on December 2, 2005 to relieve the General Court of some of the caseload on the basis of the Treaty of Nice. It will hear and determine at first instance disputes involving the European Civil Service. The creation of a European Patent Tribunal is currently being examined.

1.2.1 Jurisdiction of the ECJ

The two main sources of the ECJ's jurisdiction are (1) references for preliminary rulings from national courts under Article 234 of the EC Treaty⁸ and (2) direct actions comprising (i) infringement actions under Articles 226 and 227 of the EC Treaty⁹ and (ii) reviews of legality under Article 230 of the EC Treaty. The Court has jurisdiction in a variety of other matters involving smaller numbers of cases¹⁰. Table 1 presents figures for the types of new cases for the period from 2007 to 2013.

Table 1. Nature of ECJ proceedings 2007–2013.

Nature of proceedings	2007	2008	2009	2010	2011	2012	2013
References for a preliminary ruling	265	288	302	385	423	404	450
Direct actions	222	210	143	136	81	73	72
Appeals	79	78	105	97	162	136	161
Appeals concerning interim measures or interventions	8	8	2	6	13	3	5
Opinions of the Court		1	1			1	2
Special forms of procedure	7	8	9	7	9	15	9
Applications for interim measures	3	3	2	2	3		1

Figures obtained from ‘Statistics concerning the Activities of the Court of Justice’, Court of Justice Annual Reports, 2011 and 2013, available at: http://curia.europa.eu/jcms/jcms/Jo2_7032/

As Table 1 indicates, the vast majority of new cases are references for a preliminary

⁸ Treaty establishing the European Community (Consolidated version 2002), Article 234 provides the conditions under which the ECJ has jurisdiction to give preliminary rulings.

⁹ The two articles are respectively related to the direct actions that might occurred between the Commission and Member States, and the Member States against each other.

¹⁰ “Others” could be appeals, such as appeals concerning interim measures; opinions or rulings; and special forms of procedure.

ruling and direct actions. In addition, according to the ECJ's annual reports, taxation is the subject matter of the most new cases¹¹. Figures 1 and 2 indicate the number and percentage of taxation cases among the references for a preliminary ruling.

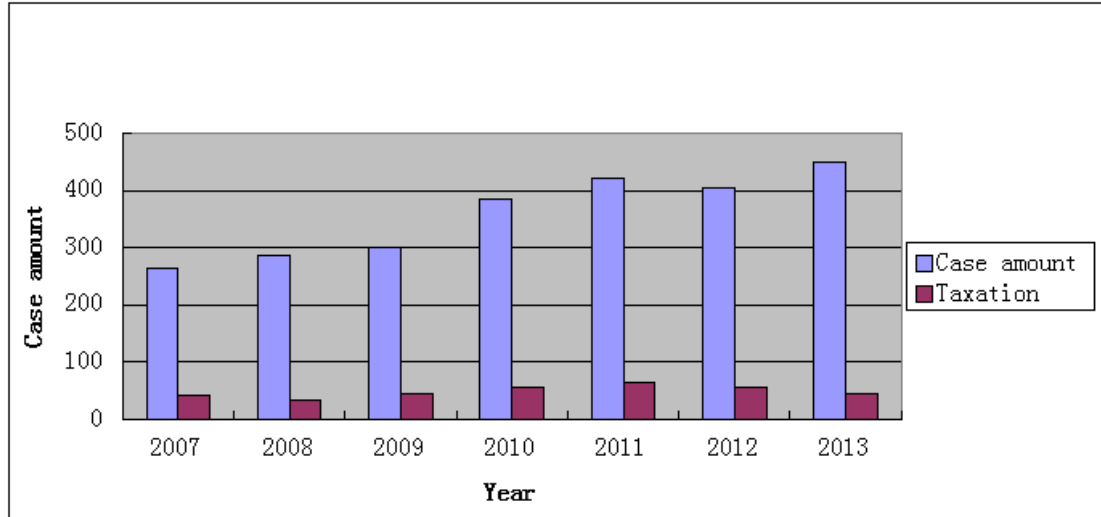


Figure 1. Number of taxation cases among new references for a preliminary ruling 2007–2013.

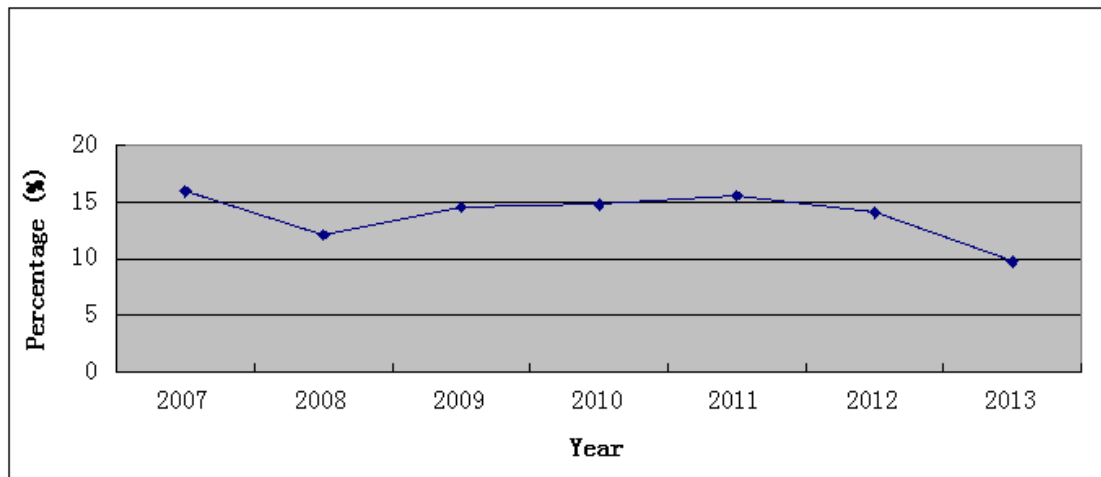


Figure 2. Percentage of taxation cases among new cases of preliminary ruling 2007–2013.

Among the taxation cases, more than 50% were VAT cases, of which cases concerning

¹¹ The subject matter of these actions are categorized in about 40 types, such as company law, state aid, environment, etc.

VAT deduction formed a large part¹². Thus the case law emerging from the ECJ in the last four decades since the adoption of the European VAT system plays an important role in the development of this system. On certain occasions, the case law is viewed as a complement to or an important component of legal harmonization within the EU, especially in the field of VAT, where the effort at harmonization basically through directives—leaving a large discretion to the Member States—makes the judgments of the ECJ bear more responsibility and significance in the implementation of European VAT law. The influence of the case law on the right of deduction in VAT will be discussed in detail in Chapter 3.

1.2.2 Procedure of the ECJ

In light of the above, the main opportunity for the ECJ to intervene in VAT cases is in references for a preliminary ruling, which means it normally does not decide the outcome of a case, but by delivering its interpretation of the European law at issue it refers the matter back to the domestic court. Therefore, the ECJ relies largely on formal written submissions and only a limited oral presentation is allowed. However, the formal written submission or oral presentation is not limited to actual parties involved in a certain case, as the Commission, the Council and other Member States are entitled to submit written comments to the court or give oral evidence.

To arrive at a decision, the ECJ usually places considerable reliance on the opinion of the Advocate General who writes a profound analysis of the merits of the arguments raised for the Court. The final judgment does not always follow the opinion of the Advocate General, however.

1.2.2.1 Interpretative methods in VAT cases

Various interpretative methods are applied by the ECJ in reaching decisions in VAT cases, in particular, strict interpretation, historical interpretation and teleological interpretation. Among these, the teleological interpretation method is undoubtedly the one that gives rise to the most radical decisions that have the biggest influence on the

¹² It would be impossible to undertake here a statistical analysis of the Court's cases in all areas of VAT, but of the cases filed in recent years, the right of deduction is a main area in VAT cases.

development of the EU VAT system and result in the most controversy as well.

The teleological or, more particularly, purposive approach is an interpretative method that entails an interpretation in light of the objectives, purposes and aims of the provisions of EU law. Thus, in VAT cases, to interpret a specific provision by the teleological method, the overall scheme of VAT will be considered and the specific provision will be put into the border context. In its more than four decades of existence, the ECJ has affirmed the importance of the principles of VAT as set out in VAT legislation and the relevant EU law. The principles of EU VAT law could be listed as: non-discrimination¹³, proportionality¹⁴ and legal certainty, and all other principles associated with the rule of law'. When it comes to the subject of the right of deduction, the principle of EU VAT plays a rather more important role in the Court's judgments.

1.2.2.2 Principles in the ECJ's decisions on VAT cases

Besides the general principles applied by the ECJ in tax cases as in any other types of cases, namely, the principles of non-discrimination¹⁵, proportionality¹⁶ and legal certainty¹⁷, the Court also applies a set of principles specific to VAT cases. Referred to herein as VAT principles, they are inferred either from the requirements of the inherent legal character of VAT or the specific mechanism in itself.

(1) Principle of neutrality. The neutrality inherent in VAT is the fundamental element for it to be chosen as a common turnover tax in Europe. Naturally, it is a basic principle to be applied in VAT cases and may be invoked in almost every aspect of its

¹³ This principle is established in Article 12 of the EC Treaty, more frequently applied in direct tax cases. Within the area of VAT, it has been applied a few times.

¹⁴ This principle has significant importance in VAT cases, especially in cases regarding the exercise of the right to deduct. See cases C-361/96, [1998] ECR I-3495; and C-390/96, [1998] ECR I-2553.

¹⁵ This principle has been applied only a few times in VAT cases, mainly in the cases in relation to intra-Community transactions, to preclude a Member States from applying less-favored rules for the taxpayer established outside its territoriality compared with its domestic taxpayers: e.g., C-361/96, [1998] ECR I-3495; and C-390/96, [1998] ECR I-7281.

¹⁶ This principle has been expressly invoked by the Court in VAT cases, such as in the joined cases C-286/94, C-40195 and C-47/96, [1997] ECR I-7281, which was related to the measures governing the exercise of the right to deduct.

¹⁷ Along with the principle of legal certainty there are always the legitimate expectations. The Court has consistently reiterated this principle in VAT cases, such as case C-381/97, [1998] ECR I-8153, at paragraph 26, and joined cases C-354/03, C-355/03, C-484/03, [2006] ECR I-483, at paragraph 41.

implementation, namely the scope of the tax, exemptions, tax rates and the right to deduct, etc. Meanwhile, a set of sub-principles is derived from its application, such as equal treatment and elimination of distortions in competition.

(2) A tax on consumption. VAT, as an indirect tax, is a tax imposed on the final consumption, which is one of its legal characters (the legal characters of EU VAT will be elaborated in section II). This principle directly defines the scope of VAT. It is expressed in Article 1(2) of VAT Directive 2006: “The principle of the common system of VAT entails the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services”. In fact, the principle was established in the case *Jürgen Mohr v. Finanzamt Bad Segeberg* before it was written in the Directive. In this case, the ECJ stated in its judgment (paragraph 19) that “VAT is a general tax on the consumption of goods and services” according to Article 2(1) of the First Directive¹⁸. The ECJ held that compensation paid by the government for discounting milk production was outside the scope of VAT.

(3) The right to deduct input VAT. Deduction of the input VAT is a crucial mechanism in the VAT system to ensure its legal character and the principle of fiscal neutrality¹⁹. Thus, it has been an important principle for the Court to give its primary ruling in the implementation of VAT directives and the other legal instruments. According to *Rita de la Feria*²⁰, the Court has determined that the principle established in Articles 1, 167 and others of VAT Directive 2006, implies the following rules:

Limitations and derogation to the right to deduct are only permitted insofar as they are expressly provided for in the Sixth Directive (*Commission v. France*²¹); the right to deduct must be exercised immediately in respect of all taxes on transactions relating to

¹⁸ The First Council Directive (67/227/EEC) of April 11, 1967 on the harmonization of legislation of Member States concerning turnover taxes (OJ, English Special Edition 1967 (I), p.14).

¹⁹ This is confirmed by the Court in *Rompehman* (Case 268/83, [1985] ECR 655), in its judgment it stated the deduction system ensures that, under the common system of VAT, all economic transactions are taxed in a wholly neutral way.

²⁰ See *Rita de la Feria*, *The EU VAT System and the Internal Market*, IBFD, 2009, p.265.

²¹ Case 50/87, [1998] ECR 4797.

inputs (*INZO*²²); and, for the right to deduct to exist there must be a direct and immediate link between a particular input and a particular output transaction or transactions (*Midland Bank*²³).

Other than the three typical VAT principles, there of course exist other principles as well, such as the principle of no double taxation, which are not typical of VAT cases, but are more frequently applied in cases of direct taxation.

2. Legal instruments of the EU

The effective functioning of a multinational organization could not be maintained only by well-organized institutions, but depends largely on its internal rules—the “carriers” to implement its common policies, which are the essence of multinational integration and are based on common legislation. Among the diverse “carriers”, legal instruments are important to the implementation of the common policies. On the level of EU law, in general, an instrument has legal effect only if a treaty provision empowers the competent institutions (the European Parliament and/or the Council) to enact it. Article 288²⁴ TFEU (ex Article 249 TEC) provides for five forms of legal instrument, and because of the special relationship between the EU and the Member States—the interests of the former and the sovereignty of the latter²⁵—each form of instrument has a different effect on the Member States’ legal systems, and accordingly, the legal instruments are categorized as set out in the following sub-sections based on their binding force on the Member States.

2.1 Directly applicable in its entirety

To be directly applicable means that a legal instrument is binding in each of its elements and does not permit the Member States to make progressive adjustments to

²² Case C-110/94, [1996] ECR I-857.

²³ Case C-98/98, [2000] ECR I-4177.

²⁴ To exercise the Union’s competences, the institutions shall adopt regulations, directives, decisions, recommendations and opinions.

²⁵ In fact, according to the ECJ, the Member States have definitively transferred sovereign rights to the Community (and now the Union) they created, and they cannot subsequently go back on that transfer through unilateral measures [see Case 6/64], unless they decide to break away from the EU. However, in practice, the situation could be more complicated and EU law, especially in the field of VAT, is more or less the result of the compromise between the Member States and the EU.

that legislation; in other words, the EU instrument has a definitive precedence over the Member States. According to the scope of their direct legal binding force, these instruments could be categorized as a regulation or a decision.

The regulation is the most effective legal instrument provided by the TFEU, as it could be viewed as a European law which could substitute for the national law—it works in the same way as the national law, giving rise to rights and obligations directly applicable to the citizens of the Member States. Thus the regulation has a general scope, binding European institutions, Member States and individuals.

Unlike the regulation, a decision's scope could be much narrower, having binding effect on the addressees whom it indicates, who may be one, several or even all the Member States or one or more natural or legal persons. As the decision has certain subjects, it takes effect on its communication to the addressees rather than on its publication in the Official Journal. Because of its direct effect, the national jurisdiction must safeguard the rights of individuals affected by a decision, which has been repeatedly confirmed by the ECJ²⁶.

2.2 Instruments with restricted binding effect

Restricted effects could be viewed in comparison with the above-mentioned “directly applicable” instruments, which means a legal instrument with restricted binding effects requires (or permits) the Member States to choose the forms and instruments

²⁶ See C-9/70, in which, the plaintiff brought a direct action before the Finanzgericht München (Munich Finance Court) based on Article 4 of the Council Decision of May 13, 1965 on the harmonization of certain provisions affecting competition in transport by rail, road and inland waterway (65/271/EEC) (a decision being addressed to Member States), its content reads as follows: “Once a common system of turnover tax has been adopted by the Council and brought into force in the Member States, the latter shall apply that system, in a manner to be determined, to the carriage of goods by rail, road and inland waterway. By the date when the common system of turnover tax referred to in the preceding sub paragraph has been brought into force, that system shall, in so far as the carriage of goods by road, by rail and by inland waterway is subject to specific taxes instead of to the turnover tax, replace such specific taxes.” One of the questions being referred for a preliminary ruling is, does Article 4 of the Council Decision of May 13, 1965 (65/271/EEC) in conjunction with Article 1 of the First Council Directive of April 11, 1967 on the harmonization of legislation of Member States concerning turnover taxes (67/227/EEC) produce direct effects as regards the legal relationships between Member States and individuals and do these provisions create individual rights which Member States must protect? The Court made its conclusion that this provision imposes on the Member States obligations, which are capable of producing direct effects in the legal relationships between the Member States and those subject to their jurisdiction and of creating the right for the latter to invoke these obligations before the courts. See also Joined cases C-100/89 and C-101/89.

necessary for complying with it. Rather than it being “directly” applicable, Member States have discretion to transpose it into national law. The directive is a typical type of instrument with restricted binding effects; this is the main legal instrument applied to harmonize European VAT. Normally, a directive sets objective/s to be achieved and all the Member States to which it is addressed are bound by it and are obliged to adopt the national measures necessary for implementation of the directive within time limits set by it, with discretion as to the means they use to transpose it into national law adapted to their special national circumstances²⁷. In VAT Directive 2006, for example, in attempting to approximate the rate, the Directive provided that the standard rate shall be not less than 15%, and set out the categories to which the reduced rate could apply. Directives are generally published in the Official Journal, but take effect by virtue of being notified to the Member States to which they are addressed.

The directive has its advantage in the harmonization of national laws in the beginning, as it enables the Member States to make adjustments in accordance with their national special circumstances and it does not pose too much of a threat to the Member States’ sovereignty. This is also the reason for the EU to choose the directive as the main instrument to harmonize VAT, which is highly sensitive to a state’s fiscal sovereignty. At the same time as deepening harmonization, however, this advantage can become an obstacle, as I will discuss in detail in the next section.

2.3 No binding effects

In addition to the regulations, decisions and directives that form the European law, the common policies of the EU can also be attained by non-binding concerted action, which means instruments used by the EU that do not impose any legal obligation on the addressees—Member States and/or citizens. The instruments with no binding effects provided for in TFEU are the “recommendation” and the “opinion”. The Council and the Commission usually use the former to suggest a certain line of conduct or outline the goals of a common policy, and the latter to assess a current

²⁷ Nicholas Moussis, *Access to European Union—Law, Economics, Policies*, European Study Service; 15th edition (April 15, 2006).

situation or certain facts in the EU or the Member States. Compared with directives, these instruments are more flexible, as they are totally without any binding force. Nevertheless, recommendations and opinions play a significant role in the coordination of national legislation or administrative practices.

In addition to the five instruments provided in TFEU, the Council and the Parliament will also adopt “resolutions”, which also lack binding effect, to suggest a political desire to act in a given area.

2.4 The effect of European law

European law is composed of legislation with binding effects, namely regulations, decisions and directives. Unlike the implementation of the law in a State, the application of European law depends largely on the separate jurisdictions of Member States. However, the European institutions, especially the Committee, which is responsible for the implementation of European law or other common policy of the EU, have the obligations and rights to ensure the Member States show proper respect for EU law and to take steps in the event of a violation²⁸. This effect suggests that individuals (any citizens of the Member States) could quote European law to guard their rights authorized thereby, especially in circumstances where the national law is in conflict with the European law, except where the ECJ (the only body that has the jurisdiction) has determined that a European act is invalid.

3. The EU VAT legislative system

From a broad view, both European legislation and jurisprudence are consistent on the EU VAT legal system. The institutions and procedures involved are respectively separate and connected with each other as well.

²⁸ The ECJ has observed that domestic laws must be reconcilable with the need to apply European law uniformly so as to avoid unequal treatment of economic operators (Joined Cases 205/82 to 215/82). The authorities of Member States, including the courts, must ensure compliance with the principle of uniform interpretation of directives, in the light of their wording and purpose (see Case C-462/99). In case of conflict of laws, the national judge must not, according to the ECJ, apply any contrary clauses of the national law, whether these are prior or subsequent to European law (see Case 92/78). While national courts may consider whether a European legislative act is valid, the Court alone has jurisdiction to determine that a European act is invalid (see Joined cases C-143/88 and C-92/89 and Case C-119/05]. See http://www.europedia.moussis.eu/books/Book_2/2/3/3/index.tkl.

3.1 The legal instrument applied in EU VAT

As mentioned above, the main legal instrument applied in the issue of the harmonization of European VAT is the directive, which has restricted binding effect. The harmonization of VAT does not have a long history in comparison with the harmonization of direct taxation in Europe. The typical feature of a directive is that it is not directly applicable, which gives the Member States space to design the specific methods and forms adopted in their national legislation to achieve the object or satisfy the requirement specified in the directive. Thus, the directive has both mandatory and flexible aspects. Regarding the former, citizens could invoke the provisions of a directive to take action against the relevant national authority for failing to fulfill the demands of the directive in a national court or even in the European juridical system.

With the deepening of harmonization, however, the disadvantage of the directive becomes increasingly evident, that is, its less mandatory effect. The original intention of the directive or any other form of legal instrument is to promote harmonization of the Member States in certain areas with the final aim of establishing a single market in Europe. In the implementation of directives, the less mandatory force and the large discretion assured to the Member States makes this process more difficult. The directive, which was once an instrument to promote harmonization, has become an obstacle in the current situation. Thus there are calls, in order to promote further harmonization of VAT, to use legal instruments with more mandatory effect, such as the regulation. I would argue that this could be very difficult. VAT represents a large percentage of Member States' fiscal revenue, which means that it occupies a crucial position in their national fiscal sovereignty. The goal of applying the regulation as a legal instrument in the harmonization of European VAT requires unanimous approval among the Member States under the current procedure applied by the EU, which is also a thorny issue at present. In addition, the EU faces a common problem as a multinational organization in the very specific national circumstances of every single Member State, from level of economic development to cultural background. This is a difficulty confronted even in a united country with diverse districts and different

peoples, such as China, not to mention an international organization like the EU composed of more than 20 countries²⁹.

3.2 The procedures involved

Rules should be followed to reach a consensus on an issue, this is the same situation around the world, and the EU is no exception.

3.2.1 The co-decision procedure

The legal procedure for the adoption of a VAT directive is the ordinary legislative procedure, also called the co-decision procedure, which is introduced in the beginning. This procedure shows equal respect to both the Council and the Parliament³⁰, which represent respectively the interests of Member States and the citizens, and in addition, forms the precondition for the subsequent implementation of the legislation being approved. One of the obvious problems, however, is the “dystocia” of a common legislation, which makes it difficult to put the common policies into practice.

3.2.2 The decision-making principle

Another element that might impede the achievement of a consensus in the harmonization of VAT is the voting principle adopted in the decision-making procedure—unanimity. In short, unanimity as a voting principle requires the agreement by all participants in a given situation, every subject must be of the same mind and acting together as one. Apparently this is rather difficult to achieve, especially in a Union enlarged to 28 Member States. Therefore, the Treaty of Lisbon, which aims at modernizing and improving the decision-making process of the EU, extends voting by qualified majority to a large number of policy areas³¹. The extension of the qualified majority voting covers the following areas, as provided by

²⁹ At the time of writing, the EU has 28 Member States and is still in the process of enlargement. The rapid enlargement of the EU is also one of the origins for the difficulty of promotion of the integration of the economy, especially the harmonization of VAT.

³⁰ Actually, the Parliament has weaker powers than the Council in some sensitive areas, and does not have legislative initiative. However, because of its democratic nature and growing powers, it has been said that it is one of the most powerful legislatures in the world.

³¹ The extension of qualified majority voting is a central part of the institutional reform of the EU associated with enlargement. Extending qualified majority voting is vitally important in an enlarged Union where unanimity will become ever more difficult to attain.

the Treaty: institutional provisions, freedom, security and justice, and common foreign and security policy (CFSP)³² and other policy areas, but the Treaty does not mention the sensitive fiscal area. In fact, before the Treaty of Lisbon, a more radical Treaty, named the Treaty Establishing a Constitution for Europe³³, was signed in Rome on 29 October 2004 and was due to come into force on 1 November 2006 if it was ratified by all Member States. However, it was finally abandoned, after being rejected by France and then the Netherlands, and was replaced by the Treaty of Lisbon. In the draft of the Constitution Treaty, approximately 20 provisions were extended to apply the qualified majority, among which the most impressive was in the “internal market” section, Article III-62: the Convention proposes that measures relating to administrative cooperation or to combating tax fraud and tax evasion the field of indirect taxes may be adopted by qualified majority, after the Council of Ministers has taken a unanimous decision³⁴. This provision was not included in its substitute treaty, the Treaty of Lisbon, however. From the experience of history, there is still a long way to go in the effort to replace the unanimity principle with the qualified majority voting principle and in the field of indirect legal instruments (especially VAT) it seems that it will take much longer, if it can ever be arrived at.

³² Voting by unanimity remains the rule of principle for decisions taken in the area of CFSP, Article 31 of the TEU nevertheless sets out four exceptions to this rule. The Council shall adopt by a qualified majority: decisions defining Union actions or positions on the basis of a European Council Decision; decisions defining Union actions or positions proposed by the High Representative of the Union for Foreign Affairs and Security Policy; decisions implementing Decisions which define Union actions or positions in the area of the CFSP; the appointment of a special representative proposed by the High Representative.

³³ Commonly referred to as the European Constitution or the Constitutional Treaty, was an unratified international treaty intended to create a consolidated constitution for the EU. It would have replaced the existing EU treaties with a single text, given legal force to the Charter of Fundamental Rights, and expanded qualified majority voting into policy areas which had previously been decided by unanimity among Member States.

³⁴ Certain legal bases will however remain subject to a unanimous vote either totally or partly, notably non-discrimination and citizenship, **taxation**, social policy, most decisions concerning common external and Community policy, certain provisions concerning immigration and the conclusion of international trade agreements. In these cases, the Convention has not been able to reach agreement making it possible to switch over to the qualified majority vote.

Section II The harmonization of EU VAT in the context of the internal market

1. The legal source for harmonization

The specific provisions which address indirect tax are contained in Articles 95–99 of the Treaty on the European Union³⁵ (hereinafter TEU). Articles 95 and 96 prohibit fiscal discrimination against products from other Member States in importation and exportation (prohibiting subsidies). The two articles prohibit fiscal discrimination in “internal taxation”, which extends beyond VAT. Article 97³⁶ has its history in the problem of the existence of diverse “cascade” tax systems in the Member States, which pre-date the introduction of the common VAT system. Article 98 prohibits the border tax adjustments to compensate for the differing incidence of direct taxation (charges other than turnover taxes, excise duties and other forms of indirect taxation), unless the measures contemplated have been previously approved for a limited period by the Council acting by means of a qualified majority vote on a proposal of the Commission. Article 99, finally, is the provision that serves as the legal basis for the adoption of VAT directives. It reads as follows:

The Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the Economic and Social Committee, adopt provisions for the harmonization of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonization is necessary to ensure the establishment and the functioning of the internal market within the time limit laid down in Article 7a.

Article 99 is explicit on the requirement of harmonization of indirect taxation insofar

³⁵ Here refers to its origin version , also called the Maastricht Treaty, which was signed on February 7, 1992 in Maastricht, and entered into force on November 1, 1993 during the Delors Commission. Notwithstanding the fact that the origin version differs significantly from its present consolidated form of 2012, the former one plays an active role in the history of the harmonization of VAT in Europe.

³⁶ This article was not amended in the TEU, it was in the Treaty establishing the European Economic Community, which was signed in Rome in 1957, bringing together France, Germany, Italy and the Benelux countries in a community whose aim is to achieve integration via trade with a view to economic expansion. After the Treaty of Maastricht the EEC became the European Community, reflecting the determination of the Member States to expand the Community's powers to non-economic domains.

as is necessary for the establishment and proper functioning of the European internal market.

2. Definition of terms

For the convenience of readers and a better discussion of the topic, the definitions of certain terms in this thesis are clarified in the following sub-sections.

2.1 The legal character of EU VAT

The legal character of a tax means the basic nature of a specific type of taxation. Once established, it should be strictly executed throughout all the stages of the taxation, from the initial design of its operation to dispute resolution. In other words, the legislative structure and the interpretation of terminology should be guided by the legal character³⁷.

The legal character of EU VAT could be summarized as: a multistage indirect tax generally applied to domestic consumption, which has achieved consensus since its birth as a common turnover tax in the EU.

2.1.1 A multistage tax

Multistage is corresponding to single-stage, which means VAT is charged throughout the production and distribution stages (from manufacturer to retailer)³⁸. This character gives the EU VAT both advantages and disadvantages.

The advantage is obtained by the deduction mechanism adopted in the stages before the goods or services enter the stage of final consumption. Thus an audit trail is formed by the invoices issued for the purpose of VAT deduction, which naturally increases the initiative for compliance of taxpayers and makes it harder to avoid than a single-stage sales tax. However, just like a double-edged sword, the nature of EU

³⁷ See Ben Di Terra and Julie Kajus, *A Guide to the European VAT Directives: Introduction to European VAT 2007*, Volume 1, IBFD 2011, p.274.

³⁸ Multiple-stage tax could be further divided into an all-stage tax (*Allphasen-Steuer*) and a dual-stage tax (*Mehrphasen-Steuer*), the theory for these systems originates from Germany. According to whether there is a cascade effect, multiple-stage tax can be divided into two groups: (1) cumulative multiple-stage levies; (2) non-cumulative multiple-stage levies. For an analysis of the two groups, see Di Terra and Kajus, *A Guide to the European VAT Directives*, p. 293-296.

VAT as a multistage tax creates high costs of compliance for business and the taxation authority alike, which is the basis of criticism for its inefficiency. Still this is a typical characteristic of VAT and has been proved to be an unalterable feature of this form of taxation.

2.1.2 An indirect tax

The *Oxford English Dictionary* defines indirect tax as a tax that is:

not levied directly upon the person on whom it ultimately falls, but charged in some other way, especially upon the production or importation of articles of use or consumption, the price of which is thereby augmented to the consumer, who thus pays the tax in the form of increased price.

From this definition, it could be deduced that the classification of a tax as direct or indirect is based on the assumption that the tax burden can be totally shifted backward or forward, which seems unhelpful to many scholars as that is not always the situation from an economic perspective. From the legal perspective, however, it is an obvious characteristic which cannot be ignored, as it is not only critical in the process of legislation and implementation of the tax, but also determines its legal character—a tax on consumption. In fact, the feature of indirectness is closely connected with the above-mentioned character of a multistage tax as, to be directly levied, the one who actually bears the tax liability should be identical with the legal taxpayer, which means the tax should only be levied directly on the final consumer in the retail stage, which is obviously not the case here.

It is the legal character of “indirect tax” that requires the possibility of shifting forward, in other words, the legislator has to ensure the forward shifting in the legislation of VAT rules. Furthermore, the tax charged should not be influenced by the extent of vertical or horizontal integration, which is a basic requirement of the principle of neutrality.

2.1.3 A general tax

VAT is a general tax as opposed to a specific tax³⁹, meaning that VAT is a tax to be charged on all private expenditure. One result of this is that VAT should be taxed both on goods and services as long as they fall within the sphere of private consumption (the legal character of a tax on consumption is explained in the subsequent section). The reason for the emphasis on non-discrimination between goods and services is the practical difficulties⁴⁰ faced in the taxation of services. This is one of the reasons for some developing countries not imposing VAT on services when initially adopting VAT as a form of taxation. China is an example of this, and now a reform to expand the scope of VAT to services is ongoing in order to resolve the problem caused by only taxing the supply of goods⁴¹.

The second requirement inferred from the general character of a tax is “equality”: the equal is treated equally and the unequal in proportion unequally⁴². A further reasoning of the requirement of equality is the equal treatment of domestic products and the products being imported. This is because, due to the character of indirect taxation, products are usually exported without being taxed.

2.1.4 A tax on consumption

In the literal sense, VAT is imposed on consumption, but not production. This characteristic, together with its multistage character, brings about the right of deduction. A correct understanding of “consumption” is important to the comprehension of this characteristic. Two aspects should be kept in mind to

³⁹ Excises are examples of the specific tax.

⁴⁰ The difficulties present at least in the following three aspects: (1) the selection of the services to be taxed, how to treat the non-business services, such as the services with an educational, medical or social nature; (2) the result of taxing labor resulted from taxing services; (3) to tax on services might be discriminatory as services are often provided by small enterprises, who under the present VAT system might be out of the scope of deduction.

⁴¹ A further justification for taxing services, one of particular relevance in developing countries, is that because expenditure on services generally forms a larger proportion to the total expenditure of higher-income groups than of lower-income groups, taxing services makes a turnover tax less regressive. See Di Terra and Kajus, *A Guide to the European VAT Directives*, p. 277.

⁴² This is expressed in Case C-330/95 (*Goldsmiths (Jewellers) Ltd v Commissioners of Customs & Excise*) by Advocate La Pergola, at point 19: “There is no justification for discriminating against one category as opposed to the other. ... especially as the general character of VAT demands that what is equal should be treated equally and what is unequal should, in proportion, be treated unequally”.

understand consumption here. First, consumption is more like an immediate action, with no consideration of the continuous process of the consumption of certain goods (such as a productive machine or an item of immovable property), thus, in such a sense, the consumption here is more or less equivalent to the concept of “expenditure”. Second, a distinction should be made between consumption expenditure and production expenditure. VAT is only levied on consumption expenditure, namely, such a tax is designed to tax only private consumption, the goods or services remaining in the business sphere are not actually taxed, notwithstanding the fact that the tax is normally levied by entrepreneurs and the like who remit the tax to the state. In practice, this restriction may cause problems, such as in the sale of secondhand goods, where the goods are transferred from the consumer sphere to the business sphere with the remaining value. The treatment of secondhand goods transactions applied in the EU VAT system is the margin scheme⁴³ in order to avoid tendencies to exclude dealers out of the VAT taxable scope in second-hand goods transaction.

2.2 “Harmonization” in the context of the EU

In the context of the EU, “harmonization” is embedded in the process of European integration, which has primarily come about through the EU and the Council of Europe, though the idea of a pan-Europa is much older⁴⁴. An eternal theme in the integration process is the conflict between the need for greater European integration in an increasing number of areas of law and policy and the wish for greater flexibility and the acknowledgment of diversity in the various policy areas and national laws. Therefore, in the Treaty of Amsterdam⁴⁵, the principles of flexibility and differentiation were constitutionally recognized and have become two of the core

⁴³ In the margin scheme, dealers are allowed to pay VAT on the profit margin, which is equal to the difference between the selling price charged by the taxable dealer for the goods and the purchase price. It is also possible to include private consumers in the levy of the tax regarding the sale of certain second-hand goods..

⁴⁴ According to Ben Rosamond, one of the first to conceive of a union of European nations was Count Richard Nikolaus von Coudenhove-Kalergi, who wrote the Pan-Europa manifesto in 1923. See, Ben Rosamond, *Theories of European Integration*, Palgrave Macmillan, 2000, pp. 21–22.

⁴⁵ The Treaty of Amsterdam was signed on October 2, 1997 and came into force on May 1, 1999. Its main changes were focused on the Treaty on European Union, created by the Maastricht Treaty in 1992.

principles in the integration of European law and policy. Rather than a single emphasis on the importance of harmonization, the recognition of the diversity existing in the Member States is approved.

In light of this, harmonization in the context of the EU does not mean to establish a completely uniform organization, ignoring the differences (in all aspects) among the Member States. Flexibility and differentiation should be controlled to a certain degree, however, that is, there should be a balance between harmonization and differentiation (and flexibility). In particular in the field of taxation, there are still many aspects of the tax that constitute serious obstacles to either the establishment or the functioning of the internal market (which will be explained in the following section). To take the harmonization of VAT in Europe as an example, the broad scope of flexibility and differentiation allowed at both macro and micro level has had disastrous consequences for the EU VAT system. As will be demonstrated in the following sections, macro-flexibility is reflected through the general exceptions, options and a high degree of discretion in the implementation of certain provisions within the VAT directives. Naturally it comes to the question whether the current level of harmonization of VAT is satisfactory for the establishment and good functioning of the internal market. According to Rita de la Feria, the current European VAT law does not meet the conditions of an internal market, as indicated by historical, practical and jurisprudential analyses⁴⁶, and it is even a substantial obstacle to the functioning of the internal market. Though the latter could be rather controversial, what is undeniable and undisputed is that the VAT system as it functions at present is problematic and is in urgent need of change, which is again, in my view, dependent on further harmonization.

2.3 The internal market

In the history of the EU (established by the Maastricht Treaty in 1992), which was formerly and successively called the European Coal and Steel Community

⁴⁶ For further information of the analyses, see Rita de la Feria, “VAT and the EU Internal Market: The Paradoxes of Harmonization”, in *Traditional and Alternative Routes to European Tax Integration*, ed. Dennis Weber, IBFD, 2010, Chapter 12, pp. 293-306.

(established by the Treaty of Paris in 1951), the European Economic Community (established by the Treaties of Rome in 1957), the European Community (established by the Merger Treaty in 1967 and further developed by the Single European Act in 1986), its economic object has been expressed in different terms in official documents. The three relevant terms are used almost synonymously: common market, internal market and single market. In academia, there is discussion or even argumentation on the three concepts, including that the single market has never been applied in official documents, but is mentioned frequently in its trivial files⁴⁷. Normally, “the single market” is viewed as the popular term in daily use for the internal market, which was formerly called “the common market”. Therefore, the single market and the internal market have more or less the same meaning in the current EU, and the common market is their precursor.

In fact, these concepts—common market and internal market—have their own historical significance in accordance with the development of the EU (understood *in lato sensu*, including its predecessors). Before the complete replacement of the common market with the internal market, there was a period when the two existed simultaneously⁴⁸. It was not until the Treaty of Lisbon that the application of the term “common market” (which was still used in the Treaty of Nice) was abandoned and totally replaced by the term “internal market”. According to paragraph 2 of Article 26 TFEU, “the internal market shall comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaties.” In addition, the concepts were clarified also by the ECJ in 1982 in its decision in C-15/81⁴⁹. At point 33 of its judgment, the Court

⁴⁷ As Adrian Ogley stated in his book, “Although the European Community is often referred to as a single market, this expression represents the triumph of political hope over commercial reality.” See Ogley, *Principles of Value Added Tax*, p. 129.

⁴⁸ According to Rita de la Feria, the interaction of the two concepts of common market and internal market could be divided into three stages: (1) from 1986 to the Single European Act, during which, the internal market was contained in common market; (2) in 1990s, the two markets had their own independent areas whereas some of which were overlapped; (3) to the Treaty establishing a Constitution for Europe (TCE), the internal market completely replaced the common market. See *The EU VAT System and the Internal Market*, p. 28-34. For the last period, it is worth noting that the completely replacement was accomplished by the Treaty of Lisbon, as the TCE was not ratified.

⁴⁹ ECJ, 5 May 1982, Case C-15/81, *Gaston Schul Douane Expeditieur BV v. Inspecteur der*

held:

The concept of a common market as defined by the Court in a consistent line of decisions involves the elimination of all obstacles to intra-Community trade in order to merge the national markets into a single market bringing about conditions as close as possible to those of a genuine internal market.

In light of the above elaboration, the internal market adopted here refers to a market that

“intends to be conducive to increased competition, increased specialization, [and] larger economies of scale, allowing goods and factors of production to move to the area where they are most valued, thus improving the efficiency of the allocation of resources. It is also intended to drive economic integration whereby the once separate economies of the member states become integrated within a single EU wide economy. Half of the trade in goods within the EU is covered by legislation harmonized by the EU”⁵⁰.

2.4 The interaction between “harmonization” and the “internal market”

In the attempt to build an internal market in the EU, the gradual deepening of economic integration is required, which is the process of harmonization in itself, while harmonization is also a tool to be applied in this procedure.

In terms of harmonization of VAT in the EU, its function in the process of promoting the establishment of an internal market is a matter of debate among scholars. In particular, in the background is the fact that nowadays there is a growing dissatisfaction with the way VAT works in the EU. The question is raised whether the EU VAT is a great achievement or good result of the tax harmonization in Europe, or an obstacle to the establishment and functioning of the internal market as defined by

Invoerrechten en Accijnzen, Roosendaal [1982], Reports of Cases 1982 01409. In the case, the plaintiff Schul lodged an objection with the Inspector against the turnover tax on importation claiming that the boat had already been subject to turnover tax within the Community, namely in France, and there had been no remission of tax on exportation. The Inspector, however, dismissed the objection on the ground the levy was made pursuant to the provisions of the Netherlands law on turnover tax.

⁵⁰ European Commission. *A Single Market for Goods*. Europa web portal. Retrieved June 27, 2007.

the EC Treaty because of its failure to respond effectively to the challenge of a true single market?⁵¹ As far as I am concerned, this issue should be approached in a dialectical way. It is noticeable and cannot be ignored that some fundamental changes should take place in the light of the serious problems that exist in the current EU VAT system. This is a consensus both among VAT experts and the EU Commission itself⁵². Nevertheless, the achievement of the harmonization of the EU VAT in its not too long history still should not be derided.

Notwithstanding the fact that the current achievements of the harmonization of VAT in the EU, which have resulted in the present EU VAT model, cannot adapt to the rapidly changing economic situation in the world and the constantly updated requirements of the internal market in EU, its historical significance and the benefits brought by it cannot be totally denied. Thus, the unsuitability of the current EU VAT to the internal market's requirements cannot be attributed to the harmonization process. Actually, most of the difficulties faced by VAT in the context of the internal market in Europe exist also in other VAT systems in the world. Among these, the most difficult one is the question of VAT fraud and notably "carousel" or missing trader fraud. This is a worldwide problem in the VAT field, however, it is more pronounced in the context of the EU's internal market, as VAT is implemented by diverse states, each of which enjoys considerable discretion under the EU's harmonization rules. The approach taken by the EU to harmonization of the VAT system, not to completely unify the legal system in Europe (which is also impossible to achieve) in order to adapt and further prompt the establishment of an internal market in Europe is correct, and by

⁵¹ The view that the current EU VAT acts as an obstacle in the context of today's EU market was expressed by Rita de la Feria in her doctoral thesis, where she devotes a whole chapter to prove or elaborate her position. See *The EU VAT System and the Internal Market*, chapter 3, section 2.1 with the title: "EU VAT system as an obstacle to the establishment of the internal market", take the inter-jurisdictional issues (place of supply rules and tax administration arrangements) and convergence of VAT rates as proof; and section 2.2 with the title: 'EU VAT system as an obstacle to the functioning of the internal market', mainly proved from the non-deductible input tax.

⁵² The lag of the EU VAT which is not adapted to the development of the internal market has drawn close attention of the EU Commission, their anxiety and corresponding efforts could be found in the documents they relieved: the EU Commission itself has undertaken an in-depth review of the VAT system through a broad consultation based on a Green Paper (2010) and has recently issued a Communication (White Paper in 2011) presenting a series of future initiatives. dealing with what are considered as the most important problems (or at least those for which a solution is attainable).

token of the current problem in EU VAT, the solution is to deepen the harmonization.

3. The process of harmonization of EU VAT

Unlike a domestic type of taxation, the EU VAT does not come into being with an integral piece of legislation which is adopted by the relevant domestic decision-making institution with a profoundly prearranged design, it is rather a result of the negotiation of Member States and the compromise thereof. The history of the origin of the EU VAT system is very well documented by Ben Terra and Julie Kajus their *A Guide to the European VAT Directives*⁵³, hence I will give just a brief introduction to the history of VAT harmonization in Europe and focus more attention on the harmonization of the subject which is the topic of this thesis—the right of deduction of input VAT.

3.1 Historical overview of the harmonization process

The process of harmonization of VAT in Europe could be divided into three periods: (1) prior to EU VAT; (2) adoption of VAT as the common turnover tax in the EU; (3) transitional regime or the stage after 1992, the year the custom frontiers were removed.

3.1.1 Prior to EU VAT

During the period prior to the inception of EU VAT, the disadvantages and distortions caused by the various turnover tax systems in different Member States drew the close attention of the (then) Commission of the European Economic Community, as it impeded the objective of establishing a common market in Europe. Thus, to act on the mandate provided by Article 99 of the Treaty for the Establishment of the European Economic Community (precursor to the EC Treaty), the Commission set up working groups to study whether it was necessary to harmonize the turnover tax in Europe “in

⁵³ Terra and Kajus, *A Guide to the European VAT Directives*. The introduction of the origin of VAT is stated in Chapter 8, “Subject matter and scope”. From this, it is clear that the converging views of both the tax experts of sub-groups A, B and C and the members of the Neumark Group were decisive for the introduction of VAT as the type of turnover tax replacing the pre-existing cascading taxes that were then in force in five of the six Member States. See Michel Aujean, “Harmonization of VAT in the EU: Back to the Future”, *EC Tax Review*, 2012, 3.

the interest of the common market” and the possible methods be applied to promote such harmonization if it was required⁵⁴. The reports of these working groups established the foundations of EU VAT—a credit invoice method VAT—which resulted in the subsequent harmonization.

3.1.2 Adoption of VAT as a common turnover tax in EU

VAT was fixed as a common turnover tax in the EU by the reports of the working groups and was further harmonized by a series of directives. Among these⁵⁵, the First⁵⁶ and Second Directives⁵⁷ and the Sixth Directive⁵⁸ played the most crucial roles in VAT harmonization and the formation of its legal character. The first two Directives, which were adopted in the light of the Neumark Report⁵⁹ and the criticisms from the relevant institutions, eventually gave birth to the EU VAT. With the adoption of the first two VAT Directives in 1967, a general, multi-stage but non-cumulative turnover tax was established to replace all other turnover taxes in the Member States. However, the first two VAT Directives laid down only the general structures of the system and left it to the Member States to determine the coverage of VAT and the rate structure. It was not until 17 May 1977 when the Sixth VAT Directive was adopted that a uniform VAT coverage was established.

⁵⁴ In 1960, the Commission responded to the instruction set by Article 99 of the (original) EEC Treaty by appointing three working groups. Working group I, specially charged with the task of researching the possibilities of harmonizing the turnover taxes in the EEC, appointed three study groups: subgroups A, B and C composed of experts from the Member States and the Commission, and a special committee—Fiscal and Financial Committee.

⁵⁵ The system of numbering Directives broke down at an early stage in the Community’s legislative process. The withdrawal of some earlier Directives and proposed Directives undermined the sequential numbering system.

⁵⁶ First Council Directive 67/227/EEC of April 11, 1967 on the harmonization of legislation of Member States concerning turnover taxes. This Directive sets out the objectives of the common VAT system.

⁵⁷ Second Council Directive 67/228/EEC of April 11, 1967 on the harmonization of legislation of Member States concerning turnover taxes—Structure and procedure for application of the common system of value added tax. On January 1, 2007, the Sixth Directive was replaced by the VAT Directive 2006.

⁵⁸ Sixth Council Directive of May 17, 1977 on the harmonization of the laws of the Member States relating to turnover taxes—Common system of value added tax: uniform basis of assessment (77/388/EEC).

⁵⁹ The report released by the Fiscal and Financial Committee (chaired by Professor Fritz Neumark) in 1962, which was then in charge of studying the extent to which the disparities of public finance within Member States prejudiced the establishment of a common market which “guarantees conditions analogous to those of an internal market”.

The force that gave impetus to the further evolution of the EU VAT from a different direction was the decision of the Council of Ministers in 1970 to create a system of resources for financing the EU budget in which a part would come from Member States' VAT revenues. This decision led directly to the Sixth Directive, as the basis of assessment of the tax had to be uniform across countries as a basis for the Council's the own resources to be derived from VAT collected by the Member States. Although this resulted in a far greater degree of harmonization of the various VAT regimes in Member States, significant discretion or latitude was still allowed to them.

3.1.3 The transitional regime

The abolition of border controls on the movement of goods within the Community on January 1, 1993 marked an important step towards the creation of a single market, and the harmonization of VAT also stepped into a new period. In theory, importation and exportation no longer existed between Member States⁶⁰ and to obtain the neutrality of VAT, transactions between Member States should be taxed according to the regulation set by the original state. Meanwhile Member States were keen to ensure that revenue from domestic consumption continued to flow directly to them in order to preserve their fiscal sovereignty. Accordingly, a hybrid system called a transitional regime was set up, in which the bulk of intra-Community trade in goods is between registered traders and, as such, continues to be taxed in the Member State of destination, while goods purchased by individuals for private consumption are subject to VAT in the Member State of origin⁶¹.

Corresponding to the transitional regime, there must be a definitive VAT system⁶².

The implementation of the transitional regime resulted in numerous problems in practice, and therefore efforts to achieve a definitive VAT system are unending. In

⁶⁰ The importation and exportation were replaced respectively by "intra-Community acquisition" and "intra-Community supply"

⁶¹ The system is more complicated in reality, here just for a simple understanding, in fact, some other mechanisms were adopted in the system to collect the tax due if a destination system was to be retained for trade between registered business and certain special categories of sale. For further information on the special arrangements in the transitional regime, see Ogley, *Principles of Value Added Tax*, chapter 7.

⁶² It was not until the summer of 1996 that a work program was presented by the adoption of the definitive VAT system.

brief, the definitive VAT system is a system based purely on the original principle stated in the preamble to the First Directive⁶³:

Whereas it is not possible to foresee at present how and within what period the harmonization of turnover taxes can achieve the aim of abolishing the imposition of tax on importation and the remission of tax on exportation in trade between Member States ...

3.2 Harmonization of the right of deduction in EU VAT

In an invoice-credit method VAT, the right to deduct⁶⁴ input VAT incurred for the purposes of the business is a fundamental feature of VAT, as it is this that prevents VAT from being a cascade tax. The soul of a perfect VAT is to obtain both neutrality (the internal character in itself) and efficiency (the external requirement of the market). This implies the following two aspects in a desired VAT system: (1) the scope of VAT should be as wide as possible, to cover all business transactions; and (2) a systematic right to deduct input VAT with the least possible restriction.

These two aspects are not mutually exclusive, but closely connected; the latter especially is normally affected by the former. In the context of the EU, in the process of harmonization to achieve a common and definitive VAT regime in Europe the above two aspects are the substantial and unavoidable issues to be resolved. The harmonization of the right to deduct input VAT is an element of VAT harmonization and is also an independent area that requires special arrangements.

3.2.1 The current legislation

In the context of European VAT, the right to deduct input VAT should be understood from two perspectives: (1) the harmonization of the domestic refund system of the Member States; (2) the establishment of an intra-Community and international refund system. The latter is a natural corollary of the former, which is the subject of the VAT

⁶³ For a detailed description of the definitive system, see Ogley, *Principles of Value Added Tax*, chapter 8, and de la Feria, *The EU VAT System and the Internal Market*, chapter 2, pp. 80-88.

⁶⁴ A VAT registered business can recover VAT it has been charged by deduct amount against VAT on its own sales, as long as the expenditure represents a business expense and the relative legal requirements are fulfilled.

Directive 2006. Accordingly, the following are the main Directives related to the right to deduct input VAT at present:

- Council Directive 2006/112/EC of 28 November 2006 “on the common system of value added tax”⁶⁵ (i.e., the VAT Directive 2006). Under Title X, “Deductions”, the basic principles and mechanisms are regulated, but a large space of discretion is left to the Member States, especially in Chapter 3, “Restrictions on the right of deduction”⁶⁶.
- the Eighth Directive “on taxable persons not established in the territory of the Member State of refund”, which was replaced by Council Directive 2008/9/EC of 2010 for intra-Community VAT refunds; and,
- the Thirteenth Directive “on taxable persons not established in the territory of the Community” for international VAT refunds.

With reference to China, a united country, the right of deduction in a domestic VAT system is most relevant to this thesis. In practice, many serious problems arise from the latter two Directives, especially the procedure regulated in the Eighth Directive. The origin of these problems is the various deduction mechanisms functioning in different Member States.

3.2.2 The main problems remained in the harmonization of the right of deduction in EU VAT

The current EU VAT system is the result of the compromise of policy in its not too long history of harmonization, and is far from the most desirable outcome. At the same time, new challenges arise with the development of the modern economy, from both new transaction methods and deepening globalization.

The main difficulty or defect in the current procedure for harmonization of the right of

⁶⁵ It brings together the various provisions into one piece of legislation, so gives a clearer overview of EU VAT legislation currently in force.

⁶⁶ The internal features of the right to deduct are: integral, global and immediate deductibility of input VAT. The restrictions are against the basic principles in general. These limits result from the initial version of the Second and then Sixth VAT Directive which included restrictions of a temporary nature, until permanent provisions are adopted, which was the aim of the Twelfth Directive, which was never agreed and was withdrawn in 1996.

deduction is insufficient harmonization which is generated from both the inadequate coordination of VAT as a whole and the large discretionary space enjoyed by the Member States. From the perspective of the harmonization of VAT as a whole, the scope of VAT and the exemption system is obviously linked to the failure of proper functioning of the right to deduct input VAT.

More specifically, in the first place the scope of the VAT system remains substantially restricted because of the exclusion of certain activities, such as those of states, regional and local government authorities and other bodies governed by public law. This situation has attracted much attention from both academia and the Commission⁶⁷. Second, exemptions for certain activities, classified either as a policy choice (exemptions for certain activities in the public interest) or a technical choice (exemptions of financial services and insurance services), which also excludes the right of deduction, is also one of the reasons for the current situation.

Against the background of the modern economy, the exemptions for certain activities in the public interest may no longer be justified and they may cause serious distortions. Calls to move certain exempted areas as much as possible to full taxation are gaining more and more support. With regard to the exemptions for the financial and insurance services, great efforts were made in the past⁶⁸ to include them within the scope of full taxation, no agreement was reached, however, mainly because of the complexity and difficulties in their application.

From the perspective of the deduction mechanism per se in the VAT system, the main question is the regulation related to the restriction of the right of deduction, which is regulated in Article 176 of VAT Directive 2006:

⁶⁷ Amending these provisions was on the work program of the Commission in 2000 (EU Commission, Communication: A Strategy to improve the operation of VAT System within the context of the Internal Market, COM (2000) 348 of June 7, 2000), reiterated in 2003 (EU Commission, Communication: Review and update of VAT strategy priorities, COM (2003) 614 of October 20, 2003) and is there again in the White Paper but without any result up to now.

⁶⁸ A remarkable effort was made by Satya Poddar's study, in which, the cash-flow approach was recommended and tested, the results of the test were shared with the Commission, who published the Report giving a detailed description of a modified form of the cash flow system of VAT (The TCAADD Report) in 1996. For further information, see Poddar Satya, "VAT on Financial Services, Searching for a Workable Alternative", mimeo 2008.

The Council, acting unanimously on a proposal from the Commission, shall determine the expenditure in respect of which VAT shall not be deductible. VAT shall in no circumstances be deductible in respect of expenditure which is not strictly business expenditure, such as that on luxuries, amusements or entertainment.

Pending the entry into force of the provisions referred to in the first paragraph, Member States may retain all the exclusions provided for under their national laws at 1 January 1979 or, in the case of the Member States which acceded to the Community after that date, on the date of their accession.

Two types of difficulties exist with the above provision. One is the vagueness of the scope of the “expenditure which is not strictly business expenditure” expressed in the first paragraph. This results in a very diverse implementation in Member States and causes many distortions instead of harmonization. The second is the restrictions to some certain activities remaining in the Member States which are permitted by the “standstill” clause in the second paragraph, mainly for cars, business travel, accommodation, food and drink. There is a dilemma here, as on the one hand, it is not possible to abolish all the restrictions completely, otherwise the risk of tax fraud would be greatly increased. On the other hand, the harmonization to achieve a unique standard or a unified list to be put in force in the Member States is also impossible. Notwithstanding all the problems and difficulties inherent in making a change, a review of the complex and divergent rules on the right of deduction is necessary for a further harmonization of the tax and to better ensure the neutrality of the tax as well. Especially for the present situation—new economic models brought by the development of technology—it is both a challenge for the current VAT system and an opportunity for its reform.

Chapter 2 The right of deduction and its exercise in Europe

Section I The right of deduction

1. Circumscription of the right to deduct input VAT

VAT has been adopted by most of the countries in the world. Because of the unique political and history background of each state, however, particularly their diverse economic situations, the specific regimes of VAT are very different from one nation to the other. This is especially true for the central mechanism of a VAT system—the right of deduction.

Prior to elaborating the complicated exercise of the right of deduction, this section will begin with a definition of the concept of the right of deduction in VAT.

1.1 The right to deduct input VAT in the credit invoice method VAT

As stated in chapter I section II section 2.1, the emergence and wide spread of VAT is due largely to the deficiencies of other forms of turnover tax—the cascading of taxes. VAT overcomes this by imposing tax on the “value added” at each stage in the production and distribution chain. How to compute the “added value” was an issue at the beginning of its adoption. There are a variety of methods available and the question is which methodology is the most appropriate to determine the value added of a particular business.

In theory, there are three distinct approaches: addition,⁶⁹ subtraction⁷⁰ and credit invoice (or tax credit). The first two methods are both accounts-based methods, which means calculation of the value added relies on data aggregated over a fixed period of

⁶⁹ Under the addition method, the value added is determined by adding up its profit (not all elements have been taxed at previous stages, e.g. wages, income in the form of government subsidies, royalties and interest).

On a national scale, the addition method VAT has not been adopted anywhere. For further information, see Alan Schenk and Oliver Oldman, *Value Added Tax: A Comparative Approach*, Cambridge University Press, 2007, p. 328.

⁷⁰ This method is quite like the addition method, but it takes the opposite direction to calculate the value added. Total purchases in a certain tax period are deducted from total sales in that same period to arrive at the value added generated by the business. It is currently applied only in Japan. For further information, see Robert F. Van Brederode, *Systems of General Sales Taxation: Theory, Policy and Practice*, Kluwer Law International, 2009, 100.

time. Consequently, they cannot accommodate multiple rates, which precisely is required in the exercise of VAT, because company accounts neither separate different product categories within their sales that correspond to different sales tax rates nor distinguish inputs according to differential tax liabilities⁷¹.

Unlike the addition and subtraction methods, the credit invoice method calculates the tax on a transaction-by-transaction basis, which enables it to overcome the disadvantage of not accommodating a multiple-rate consumption tax. In principle, the tax is charged on each transaction. By this method, a company will compute its tax liability by deducting the total amount of tax paid on procurement from the total amount of tax charged on its sales for a certain period (a statutory reporting period).⁷² In order to present how this method works more intuitively, Table 2 shows a simplified model⁷³.

Table 2. The function path of deduction of tax in credit invoice method VAT.

VAT rate 10%	Sales	Tax on Sales	Total sales price	To Taxing Authority
Producer 1(PI)	1,000	100	1,100	100
Producer 2(PII)	2,000	200	2,200	200-100=100
Producer 3(PIII)	3,000	300	3,300	300-200=100
Wholesaler	4,000	400	4,400	400-300=100
Retailer	5,000	500	5,500	500-400=100
Total				500

We assume that each stage of the production and distribution chain creates an additional value of 1,000 to a single product. We take Producer 2 (PII) as an example;

⁷¹ Alan A. Tait, *Value Added Tax: International Practice and Problems*, Washington, DC: IMF, 1988, p. 5.

⁷² Generally a calendar month, quarter or calendar year.

⁷³ Van Brederode *Systems of General Sales Taxation*, p. 22.

PII gives PI 1,100 to purchase the product, of which, 100 is the tax amount. Then PII adds 1,000 in value and sells it to PIII for 2,200 (1,000+1,000+200), of which 200 is the tax amount. PII deducts 100 in tax paid to PI from the tax due (200) on his sale to PIII and remits the difference (200-100) of 100 to the taxing authority. Thus, PII, on its sale of the product to PIII, generates 200 tax due but also obtains a credit (100 paid for the obtain of the product from PI) for the tax paid to PI. To function well, each business is required to operate two book-keeping ledgers as records of the tax: one for the tax payable on sales (output tax), the other for the tax credit on procurement (input tax). Also, each business requires certification (an invoice, which will be detailed in the following section) from its suppliers to prove it has already paid VAT in order to claim the deduction. As in the example shown, tax is charged on each sale, and a tax credit arises regarding each purchase. Since the tax credit is based and depends on an invoice issued by the seller, this method is commonly referred to as the credit invoice method⁷⁴.

Of the three methods above, the addition method has not been adopted anywhere on a national level, but Israel applies it to the financial sector. The business enterprise tax which is charged in the US State of New Hampshire is also an addition method VAT levied on businesses with turnovers above a certain threshold value⁷⁵. The subtraction method is currently applied only in Japan. The credit invoice method of VAT is adopted in most countries that run a value added tax system. So what makes this third method so popular? In fact, both the subtraction method and the credit invoice method determine the value added from a subtractive perspective, that is, to deduct costs from turnover. The subtraction method takes a direct approach, like most other taxes that it first calculates the tax base out—total purchases in a certain tax period are deducted from total sales in that same period to arrive at the value added generated by the business. The credit invoice method applies an indirect subtraction, first it calculates the output tax on the sale, then determines the tax due by deducting the input tax from

⁷⁴ Other names, such as tax from tax method and tax deduction method, are used.

⁷⁵ For further information, see Schenk and Oldman, *Value Added Tax*, pp. 328, 403.

the output tax. According to Tait,⁷⁶ there are four key reasons for the credit method's unsurpassed proliferation. The most important one is expressed above; rather than being accounts-based like the other two methods, the credit invoice method is transaction-based, which makes it superior from a legal and technical perspective. The second advantage is generated by the indispensable document in its self-function chain—a mandatory invoice, which creates the audit trail and makes the method per se more practical. Third, also as mentioned above, the transaction-based method can accommodate a multiple rate VAT,⁷⁷ whereas the direct method cannot. The last reason is that the credit invoice method is the most flexible one for calculating the tax liability by different time intervals (e.g. weekly, monthly, quarterly or annual).

The features of credit invoice VAT are remarkably similar all over the world: the broad tax base, the registered taxpayers,⁷⁸ multiple positive rates,⁷⁹ and, most importantly, business purchases are relieved from the tax through a tax credit deductible from tax due on sales, which is also the topic to be discussed in detail in this thesis.

1.2 Deduction – the “right” that makes a taxpayer a “creditor”

Deduction is a crucial process in the VAT system, but what is it? In credit invoice method VAT, a business claims a tax credit for its previous procurement when it makes the sale of a product. Is the business a taxpayer of VAT, and the deduction a right enjoyed by this taxpayer?

1.2.1 Formal taxpayer and substantial taxpayer

To answer these questions, we should distinguish between the taxpayer according to the VAT statute and the true subject that substantially bears the burden of VAT, or, in

⁷⁶ Alan A. Tait, *Value Added Tax: International Practice and Problems*, International Monetary Fund, 1988, 5-6.

⁷⁷ In fact, this charter is becoming less important as it seems that over time, the lawmakers are more inclined to a single rated VAT, especially since 1990. For further information see Liam Ebrill et al., *The Modern VAT*, International Monetary Fund, 2001, pp. 20-21.

⁷⁸ Generally, small traders (traders with annual turnovers below a certain threshold) are relieved from the obligation to register but allowed to do so if this is more advantageous to them.

⁷⁹ More recently designed VAT systems generally apply only one rate, such as those of New Zealand, Australia and South Africa.

other words, the person liable for tax by statutory provisions and the person who truly bears the tax in the end.

VAT is generally imposed on taxable domestic supply of goods and services and on importation of goods and of some services. In light of the specific and complex circumstance of importation, we make our discussion and study mainly on the VAT imposed on taxable domestic supplies of goods and services.

Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax⁸⁰ (i.e., VAT Directive 2006) imposes VAT on taxable supplies by a taxable person. According to this Directive, the person liable for payment of VAT could be, in principle, the taxable person who supplies the goods or services or in certain circumstances, the person to whom the goods or the services are supplied⁸¹. The Member States shall lay down the procedures and conditions for its implementation. In practice, many countries rely on the concepts of both a registered person and a taxable person in defining transactions that are taxable and persons who are required to file returns and account for tax on taxable sales. In these countries, a taxable person subject to VAT rules is defined as a person who is registered or is required to register.

In Italy, for example, the formal and instrumental obligations imposed on subjects of VAT are multiple and most of the relevant regulations are set out in the DPR 633/72⁸². Among the obligations imposed, includes the registration of individual operations (taxable, non-taxable, exempt) made⁸³. The registration requirement is generally imposed on a person or company that makes at least a threshold amount of taxable sales.⁸⁴ Subjects that do not satisfy the amount do not have the right to deduct the

⁸⁰ Article 2 of the VAT Directive 2006 regulates the transactions subject to VAT, one of the conditions is that the transactions shall be acted by taxable person, and the definition of taxable person is specifically stipulated in Art. 9–13.

⁸¹ See, *supra*, Art. 193–205, regulate the provisions “Persons liable for payment of VAT to the tax authorities”.

⁸² Istituzione e disciplina dell’imposta sul valore aggiunto (Decreto del Presidente della Repubblica 26 ottobre 1972 n. 633 e successive modificazioni ed integrazioni).

⁸³ This can be inferred from the “Titolo ii obblighi dei contribuenti” of DPR 633/72.

⁸⁴ These taxpayers below the threshold are usually defined as small-scale taxpayers who are suitable for a simplified method for calculating the tax payable.

VAT paid in their prior transactions.

This situation also consistent with the VAT system in China. Article 13 of the Provisional Regulations on Value-Added Tax of the People's Republic of China(hereinafter PR-VAT)⁸⁵is the general provision that imposes the registration obligation:

Taxpayers other than small-scale taxpayers shall apply to the competent tax authorities for the qualification. Specifically identified measures shall be formulated by the State Administration of Taxation.

The threshold is specified in the rules for the implementation of the PR-VAT.⁸⁶

Nevertheless, the taxpayers defined as taxable persons required to register by the legal articles are not the real bearers of the VAT or at least, they do not bear the whole amounts. That is because of the tax incidence and tax shifting, neither of which are new notions: in the late nineteenth century, economists were quite aware of the essential question of who bears the burden of taxation⁸⁷. The reasons for tax shifting could be complicated and always relate to economic behavior. Put in a simple way, there exists no certainty that the burden of a given tax will rest on the person whom the legislation elected to bear it.

When it comes to VAT, it is imposed with the assumption that the taxable persons in the manufacturing and distribution chain will increase their prices with the tax and thus shift the burden fully forward to the final consumer⁸⁸. Under credit invoice method VAT especially, each individual producer in the manufacturing and

⁸⁵ Promulgated by No. 134 Order of the State Council of the People's Republic of China on December 13, 1993, amended and adopted at the 34th Executive Meeting of the State Council on November 15, 2008, become effective as of January 1, 2009. This is just a provisional regulations, contains a total of 27 articles, and no formal legislation about VAT exists yet.

⁸⁶ Article 28 of the Rules for the Implementation of the Provisional Regulations on Business Tax of the People's Republic of China sets separately 5 million and 8 million of taxable sales amount for the taxpayer engaged in different economic sectors as the threshold of the registered general taxpayer of VAT.

⁸⁷ Alfred Marshall, *Principles of Economics*, 8th ed. (1890), Philadelphia, 1920 (reprinted 1982), Ch. IX, pp. 343-345.

⁸⁸ In fact, this could not be entirely done, the extent and direction of tax shifting depend on the relative price elasticities of supply and demand. For further information, see Van Brederode *Systems of General Sales Taxation*, pp.29-33.

distribution chain could get a credit for VAT paid on the procurement to exercise against the tax collected on their sales, the tax thus becoming an add-on to the price of a product. In this way, the credit invoice method forms a mechanism to enable tax shifting in a VAT system. Therefore, in a credit invoice method VAT, the tax burden is usually borne by the final consumer, who is the substantive taxpayer.

In the VAT regime, there thus exist at least two types of taxpayers, one is the legal taxpayer (or the formal taxpayer), who bears the corresponding legal rights and legal obligations; the other is the substantive taxpayer, who actually bears the burden of paying VAT. Normally, the latter is assumed to be the final consumer, and this is why VAT is non-cumulative but in reality, because of economic factors, the situation could be more complicated, as expressed above. However, between the two types of taxpayer, the former—the taxable person regulated in the provisions—is the one who enjoys the “right” to make the deduction of VAT paid on procurement.

1.2.2 Deduction—a right or not?

Here we address the question asked at the beginning: what is the nature of deduction? Is it a right enjoyed by taxable person? If it is a right, according to the VAT system in which the deduction exists, it means an entitlement of the taxpayer ensured by the law. It is a legal right, and, as is well known, one feature of a right is that each legal right that an individual possesses relates to a corresponding legal duty imposed on others. In this logic, the tax authorities should be the corresponding duty-bearers. But, in reality, this is not the case in the practice of a VAT system. The taxpayers can claim tax deductions only if they satisfy certain conditions prescribed by law. And the taxation authorities make their decisions and actions according to the legal provisions to ensure the normal operation of the VAT system. It rarely happens that the tax authorities fulfill their duty to the taxpayer. In addition, another feature of a right is that those who enjoy the right have the choice whether to exercise it or not. In the circumstance of a VAT system, the deduction of VAT paid before the sale is essential to the final determination of the amount of tax due. In the VAT systems of most

countries, there are mandatory registration⁸⁹ provisions whereby a taxable person whose business reaches the threshold requirement for registration must register with the authorities. Benefits as well as VAT obligations may be limited to registered persons. One of the most important benefits is that registered persons can recover VAT paid on business inputs used in making taxable sales through the deduction. In other words, the operation of the deduction system makes the formal taxpayer a “creditor” to the tax authority. But does the taxpayer have the choice to quit the relevant “right”? Definitely not; failure to register and collect tax from customers does not relieve a vendor of the obligations imposed on registered persons to collect and remit tax. That is to say, the taxable person, from one aspect, has no option but to register,⁹⁰ from another aspect, the taxable person also has no freedom of choice to refuse to deduct because of financial interest. Only by deduction can producers shift the tax forward and not be at a disadvantage position in market competition. In the end, the right never really exists for the taxpayer, because from one aspect, the right could not be performed before the determination of the tax due and, in the second place, once the tax due has been calculated, the right of deduction ceases to exist as other legal claims arise, such as the right to a refund, which will be discussed in the following section.

However, the design of the deduction system is certainly a benefit to the taxpayer, and especially to the substantial taxpayer (the final customer) by relieving them from the cumulative tax burden. In the EU VAT Directives, deduction is straightforwardly described as “a right of deduction”⁹¹. But to my point of view, this “right” is not equal to the rigorous conception of a right for the reasons given above. Yet, this description implies an inclination to the interest of the taxpayer, stresses the service role of the tax authority and improves the compliance of the taxpayer.

⁸⁹ A person must apply for registration in a prescribed form and manner, and the application must include the information required.

⁹⁰ The achievement of the qualification is determined by the tax authority, VAT authorities may refuse to register an applicant if the authorities determine that the person does not meet the registration requirements.

⁹¹ In the title X of VAT Directive 2006, Article 167 with its opening statement: “A right of deduction shall arise at the time the deductible tax becomes chargeable.” And the whole chapter maintains a consistent description.

From a strictly academic point of view, deduction is an element which qualifies VAT as a non-accumulative taxation by playing an essential role in the process of determination of the tax due. Only by the function of deduction, calculating the difference between out-put VAT and in-put VAT, can the following steps⁹² in the value-added tax regime come into being. To ensure the correct calculation of the tax due, as well as the neutrality of the VAT tax system, calls for the cooperation of the taxpayers by exercising their “right” to deduct the amount of tax they have paid in their procurement. So, rather than a “right” enjoyed by the taxpayers, I would treat deduction as a tool or a mechanism designed to determine the amount of tax due in order to assure the neutrality of the VAT system, which demands the cooperation of the taxpayers by exercising the deduction. For simplicity of expression and ease of understanding, however, I will use the concept of the “right” of deduction in this thesis.

1.3 The relationship between deduction and refund in a VAT system

How does the right to a refund come into being? There are chiefly two reasons: one is related to the export of the goods and services. Most countries define the jurisdictional reach of their VAT under the destination principle⁹³ by which exports are free of tax (zero rated). By this means, it brings out the excess input VAT. The other cause is related to registered taxable persons making sales taxable in the domestic market, which could not occur frequently, but still may take place occasionally, such as the substantial input credits generated by capital purchases or an increase of inventory to expand a business. One of the treatments of the excess tax paid is to enable the taxpayer to reclaim the difference from the tax authorities, that is, the right to a refund. We can see that both the processes (deduction and refund) in VAT grant the taxpayer a

⁹² In case that there is an excess of the input tax, taxpayer could carry forward to the successive tax period or to make a refund according to the national VAT system. Article 183 of VAT Directive 2006: “Where, for a given tax period, the amount of deductions exceeds the amount of VAT due, the Member States may, in accordance with conditions which they shall determine, either make a refund or carry the excess forward to the following period.”

⁹³ A country with a VAT must define the jurisdictional reach of the tax, usually there are two choices—the origin principle and the destination principle. Under the former principle, the tax shall be imposed by the country from which it is exported; under the latter one, the tax is charged by the import country.

“right” enforceable against the taxation authority. However, there are differences. I use VAT “refund” to mean one of the measures to deal with the excess amount of input VAT. In the EU VAT system there also exists the right to a refund in the situation that businesses operate in countries in which they are not established or registered (i.e. nonresident businesses)⁹⁴.

The VAT taxpayers of different legal systems might enjoy the following rights in the procedure to determine their tax liability: the right of deduction, the right to carry forward the excess deductible amount, the right to a refund, on the condition that they fulfill the relevant requirements⁹⁵. Among these, the right of deduction is definitely the most important one as it was the first to emerge and lays the foundation for the development of subsequent tax positions related to the excess deductible. In fact, without the correct exercise of this right, the subsequent tax positions and rights could not come into being: in this way, the right of deduction affects the right of refund in VAT⁹⁶. And the two rights belong to two different phases of a VAT system: the phase of the determination of the tax due and the phase for the treatment of the over-amount VAT deductible, both phases consist of the process for the recovery of VAT deductible. To make this clear, we should first appreciate the significance of the right of deduction. In the first place, from the aspect of the taxpayer, regardless of the enforcement mechanisms and the purposes of the tax itself, the deduction is considered as a tax credit; in the second place, it is understood that the deduction was the pivot of the structure of VAT, it is been so qualified just because it is a right strictly related to the determination of the tax due (and the pursuit of neutrality) and

⁹⁴ Producers under this circumstance can incur significant amounts of VAT on expenses paid in those countries. In principle, non-resident businesses should be able to recover some or all of the VAT incurred, thereby reducing their costs. As Article 170 states: “All taxable persons who, within the meaning of Article 1 of Directive 79/1072/EEC, Article 1 of Directive 86/560/EEC and Article 171 of this Directive, are not established in the Member State in which they purchase goods and services or import goods subject to VAT shall be entitled to obtain a refund of that VAT in so far as the goods and services are used for the purposes of the following... And Article 171 regulates the specific in which the taxable person should be entitled the right to refund VAT.”

⁹⁵ According to Article 183 of the VAT Directive 2006, a taxable person whose input VAT exceeds his output VAT is entitled to a refund of the excess from his national treasury. However, Member States may decide to carry forward the excess to the next taxable period and offset it against tax due in that period.

⁹⁶ For further information, see M. Basilavecchia, *Situazioni creditorie del contribuente e attuazione del tributo. Dalla detrazione al rimborso nell'imposta nell'imposta sul valore aggiunto*, p. 104

independently configurable only in the manner and within the time prescribed by law. It is clear that the deduction may (but does not certainly) give rise to a right to claim a credit (here meaning the right to a refund of the excess input VAT deductible) only after having performed (in the terms and in the manner prescribed by law) its function in the internal procedure of calculating VAT due.

The difference described above could lead to a consideration that, in the mechanism of VAT, the right to a refund (arising from the existence of an excess credit) and the right of deduction are not legal arrangements which could be used in an alternative way. The right of deduction is not a real right;⁹⁷ however, the deduction has a necessary function in a tax with VAT purposes⁹⁸ and, as such, is not replaceable by any other legal arrangement: the mechanical application of VAT requires immediate neutralization of input tax paid in the upstream and such an effect can only be achieved with the provision of the right of deduction which can ensure an immediate and full deduction⁹⁹. It is indeed such an effect that would be inhibited if the right to a refund (not the right to deduct) applied: the taxpayer would be obliged to make a financial outlay and suffer the burden of the tax until reimbursement of the sums from the taxation authority.

In contrast, the right to a refund is not irreplaceable; according to Article 183 of the VAT Directive 2006, each state can decide how to promote the recovery of the excess subject to the condition of neutrality. With innumerable variations, there are two basic methods by which VAT systems provide for the recovery of excess input VAT: immediate refund or carried forward. Under the latter, normally the taxpayer recovers against future VAT liability, but if there is no future VAT, it is recovered either by offsetting other tax liability or turn back to the former method—refund of the excess credits.

⁹⁷ See the description in part (2) The deduction – a “right” of taxpayer, which enables a taxpayer as a “creditor”.

⁹⁸ “A tax with VAT purposes” is not informative in this thesis.

⁹⁹ The immediate and full deduction of the input tax is an important feature of the right to deduct, which is described in the second part with the title: “The characteristics of the right to deduction.”

In summary, the right of deduction and the right to a refund are two separate rights belonging to two respective stages—the procedure of the determination of the tax due and the procedure of the recovery of the over-amount input VAT deductible—in a VAT system although they are strictly related to each other. In general, the proper exercise of the right of deduction precedes the successive positions of a deductible credit, as a pre-condition to the right to a refund. The conclusion, which also forms a difference between the two rights, is that the right of deduction is so crucial to the well-functioning VAT that it could not be replaced by any other mechanisms. Meanwhile, the right to a refund is just one optional method to make the recovery of the excess deductible which is decided by the process of deduction, and may not be a preferred choice of the legislatures and tax authorities in some states because of the risk of fraud and the negative cash flow associated with it.

2. Characteristics of the right to deduct input VAT

2.1 Immediacy

Title X of the VAT Directive 2006, which characterizes the right to deduct input VAT, especially Articles 167–169, regulates two basic principles: one is the time the right to deduct input VAT accrues, and the second is the reason for the right. As expressed by Article 167, “A right of deduction shall arise at the time the deductible tax becomes chargeable.” We can see that the time of inception of the right to deduct has a legal connection with the time when the purchase of the good or service occurs, which corresponds to the time when the tax is chargeable. This principle is expressed clearly in the ECJ case law; the Court has consistently held that the right to deduct must be exercised immediately in respect of all the taxes charged on transactions relating to inputs¹⁰⁰. This immediate exercise of the right to deduct is the first feature of the right itself—immediacy. The second principle reflected in Title X is the reason for the generation of the right to deduct, which is connected to the imputation of purchase to

¹⁰⁰ See the judgment 06/07/1995, Case C-62/93, *BP Supergas*, point 18, in particular, Case 50/87 *Commission v. France* [1988] ECR 4797, paragraphs 15–17 and Case C-97/90 *Lennartz v. Finanzamt München III* [1991] ECR I-3795, paragraph 27.

the execution of active operations¹⁰¹. This will be elaborated in the next section: the requirements for the establishment of the right to deduct input VAT.

How to grant its immediacy? Apart from the unambiguous statement in Article 167, the relevant provisions of the Directive are applicable in the Member States to enable it to be fully implemented. The direct applicability is based on the conformation of comprehensive text (be clear, precise and detailed) of Community legislation. The comprehensive and exhaustive text enables the suitability of the provision to take effect within the Community. Here we need to distinguish direct applicability from direct effect, although both are consequences of the provisions being textually exhaustive. Direct applicability indicates the suitability of a provision to be implemented within the State without the need for further regulatory intervention (as being clear, precise and detailed even in regard to the content). Direct effect points out, however, the attitude of the Community provision to create rights and obligations of citizens, regardless of the fact that the national rule is pointing to the same subject. Direct applicability requires direct effect, not vice versa.¹⁰²

In addition to the direct applicability of the Community provisions which enables the immediate deduction of the input VAT, there is also theoretical support relevant to the detailed content of the specific provision that makes the taxpayer a creditor at the time the corresponding transactions are performed. This situation is not restricted to the EU and its Member States, but here I take the VAT Directive 2006 as an example. Under Community Directives (such as Article 168 of the VAT Directive 2006), the right to deduct (as defined in the terms of Community) of VAT on purchases is exercised as required by the subsequent Article 179, according to which “the taxable person shall make the deduction by subtracting from the total amount of VAT due for a given tax period the total amount of VAT in respect of which, during the same period, the right

¹⁰¹ See Article 168, In so far as the goods and services are used for the purposes of the taxed transactions of a taxable person, the taxable person shall be entitled, in the Member State in which he carries out these transactions, to deduct the following from the VAT which he is liable to pay...

¹⁰² On the direct applicability of the Community rules and the difference between the direct applicability and direct effect, please refer to G. Tesaurò, *Diritto comunitario*, Padua, 2003, p. 163.

of deduction has arisen and is exercised in accordance with Article 178¹⁰³. According to these provisions of Community legislation, for the purposes of determining the liability of the taxpayer, the tax deductible is subtracted from that levied (in advance) on taxable transactions carried out and, therefore, is essentially a right to credit of the taxable person for the purposes of determining the amount to be paid. In order not to impact the taxable person's financial status, the credit originates at the point at which the taxable transactions are conducted. The VAT payable and VAT credit are in fact financial items for the taxpayer, but only in a formal sense as in a substantive way they belong to the final consumer.

Thus, notwithstanding the fact that, due to the procedural provisions¹⁰⁴ the right to deduct could not be exercised "immediately" at the time of the carrying out of the taxable transaction, the immediacy requirement in itself is granted by the provisions which give the taxable person a credit at the time of the taxable transaction being conducted.

2.2 Integrity

Generally, a taxable person can and should be entitled to claim credit for input VAT on acquisitions (including imports and domestic purchases) of goods and services as long as they are used in connection with taxable supplies. The credit of input VAT should cover all VAT already paid on the cost of the acquisition of the goods and services that be invested to taxable transactions. This is the second feature of the right to deduct—integrity, which is essential to prevent the cascading of tax attributable to business inputs.

In practice, the integrity feature may be called into question by the procedural or formal requirements for the exercise of the right to deduct. For example, the exercise of the right depends on the issue of a document (an invoice) which serves as proof to

¹⁰³ Article 178 displays the conditions to be satisfied by a taxable person in order to exercise the right of deduction.

¹⁰⁴ As mentioned above as well as being mentioned below, the deduction is conducted under certain conditions. The registration of the subject and the restriction of the tax period, in the EU and in many countries, an input VAT is deductible only if the registered person holds a document covering the goods or services that serves as an invoice, etc. See Schenk and Oldman, *Value Added Tax*, p. 144.

certify the fact that the corresponding VAT has been paid in advance. This requirement is necessary for the tax administration and compliance. By the evidence of the invoice, on one hand, the tax authority could make an initial assessment of whether the credit of input VAT exists or not, and to what extent the credit is justified; on the other hand, the taxable person gets an incentive to issue the invoice and keep the chain of deduction complete. While, in principle, a taxable person who acquired goods or services and invested them to conduct a taxable transaction could not claim credit for the input VAT if no invoice was received, the integrity feature of the right to deduct could still not be denied by this. As Alan Schenk stated in one report: “A buyer [generally] is entitled to the input credit even if the seller does not remit the tax charged on its tax invoices. In this situation, the government’s recourse is an action against the defaulting seller, not denial of the credit to the buyer who relied on the tax invoice and who either paid the seller in good faith or is liable to the seller.”¹⁰⁵ This could be a discussion of the balance between the substantial and the formal elements in a tax affair¹⁰⁶. However, my point here is that, notwithstanding the external requirement for an invoice, the integrity feature which is inherent in VAT should not be ignored. And this is probably the reason for the exceptions in Articles 180 and 181¹⁰⁷ both of which authorize the Member States to entitle a taxable person to make a deduction without the possession of an invoice.

The integrity feature of the right to deduct should be distinguished from the proportional deduction. As the integrity is based on the VAT related to the goods or services involved in the taxable transaction, and the proportional deduction occurs in the case of goods or services used by a taxable person both for transactions in respect of which VAT is deductible (here referring to the taxable transactions) and for transactions in respect of which VAT is not deductible, only such proportion of VAT as

¹⁰⁵ Alan Schenk, “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 96” (1989).

¹⁰⁶ See point 3. Regulations set by the case law of ECJ to exercise the right of deduction in Part II.

¹⁰⁷ Article 180 states: “Member States may authorize a taxable person to make a deduction which he has not made in accordance with Articles 178 and 179.” Article 181 states: “Member States may authorize a taxable person who does not hold an invoice drawn up in accordance with Articles 220 to 236 to make the deduction referred to in Article 168(c) in respect of his intra-Community acquisitions of goods.”

is attributable to the former transactions shall be deductible¹⁰⁸. In substantial terms, the proportional deduction of the input VAT is a concrete manifestation of the integrity feature of the right to deduct it. Apart from this, there are other situations that might be confused regarding the integrity of the deduction of the input VAT, for example, there are always certain provisions about the restrictions on the right of deduction¹⁰⁹. All these are specific treatments according to certain considerations (mostly, economic, political or administrative considerations), and they are not reasons to deny the right's general and inherent nature.

All in all, the immediacy and integrity of the right of deduction in VAT are intrinsic properties which characterize VAT as a non-accumulative form of taxation and ensure the realization of the principle of neutrality in the VAT system. Thus, notwithstanding the fact—apart from the exercise and compliance conditions—that the exercise of the right in practice is usually “limited” by some procedural and formal restrictions, the features inherent in the right itself cannot be denied. In contrast, they should be kept in mind throughout the entire process of the execution of the right of deduction, but not confined to the literal expression.

3. Prerequisites for the right of deduction

The establishment of the right of deduction requires the fulfillment of relative preconditions, including substantial elements, formal elements and the time elements. The detailed requirements are either explicitly ruled in the regulations or reflected in the practice.

3.1 Substantial element: the related goods or services relate to taxable economic actions (taxable transactions) by the taxable person

3.1.1 The relative requirements regulated in the EU VAT system

In a VAT system, without considering any specific type, the right of deduction must be

¹⁰⁸ See Article 173 of VAT Directive 2006.

¹⁰⁹ Such as the restrictions regulated in Articles 176 and 177, which exclude the right of VAT deduction for certain types of expenditure (expenditure which is not strictly business expenditure, such as that on luxuries, amusements or entertainment) or for special items (such as capital goods).

based on the fact that the goods and services which generate the “pending” input VAT (whether deductible or not) are devoted to taxable transactions. And the taxable transactions must be carried out by the taxable person. In the EU, this rule is reflected in Article 168 of the VAT Directive 2006:

In so far as the goods and services are used for the purposes of the taxed transactions of a taxable person, the taxable person shall be entitled, in the Member State in which he carries out these transactions, to deduct the following from the VAT which he is liable to pay...

From this provision, we can infer three principles of the establishment of a right to deduct the input VAT: first, the subject of the relevant transaction is a taxable person; second, the existence of taxed transactions carried out by the taxable person; third, there is a link between the purchased goods and services and the taxed transactions—the purchased goods and services are actually used to taxed transactions.

First, what is the definition of a “taxable person”? As stated in the previous section¹¹⁰ the right of deduction is enjoyed by the formal taxpayer, normally the taxable person who, in principle, bears the duty of registration in a VAT system. However, apart from the requirement for registration, there are certain conditions to be a taxable person. With regard to Article 9(1) of the VAT Directive 2006, “‘Taxable person’ shall mean any person who, independently, carries out in any place any economic activity, whatever the purpose or results of that activity”. We can draw the following inferences: first, there is no restriction to the nature of the taxable person, it could be a private person or a legal person, such as a company or a partnership. But there are some special rules for public bodies. Because of their special roles in society, whether they are taxable persons depends on the roles they play when they are engaging in particular activities or transactions—as public authorities or not. But this general principle must not lead to significant distortions of competition. Another special case is individuals who, while legally independent, are closely bound to one another by

¹¹⁰ See the discussion in (2) The deduction – a “right” of taxpayer, which enables a taxpayer as a “creditor” of the first section “The circumscription of the right to deduct in VAT”.

financial, economic and organizational links. Under Article 11 of the VAT Directive 2006, the Member States are authorized to exercise the option to treat them as a single taxable person or not.

Second, there is a behavioral requirement for one to be a taxable person, that is, one must carry out economic activity. Article 9(1) defines economic activity by its actors (producers, traders or persons supplying services) and provides a particular situation to be considered as an economic activity¹¹¹. Under the VAT Directive 2006, economic activity is very expansive, but relies on an objective test—the nature and scale of the activities¹¹². There are also other criteria in different VAT systems, for example, the concept of economic activity is based on factors such as continuity and frequency of activity.

Third, in addition to a requirement for a pattern of behavior, the economic activity should be carried out independently. Article 10 explains that it is meant to exclude from VAT liability persons who are employed and others in so far as they are bound to an employer by a contract of employment or by any other legal ties. This condition is not restricted to the EU VAT, it is a common rule—services provided by an employee to an employer are not taxable services in the current VAT regimes. In practice, however, this rule may bring about inequitable results. As Schenk stated in a report, “An employee may suffer a VAT disadvantage by not being treated as a taxable person. For example, if a musician must purchase her own expensive cello, a carpenter must purchase his own tools, or a guard must purchase his own uniform, the employee must bear VAT that cannot be offset by an input credit”¹¹³. To adjust this disadvantage, there are two optional solutions: one is to enable the employee to claim credit for VAT charged on the purchases, alternatively, employers could be eligible to claim input credits for VAT on an employment-related purchase by an employee. However, both

¹¹¹ The exploitation of tangible or intangible property should be treated as an economic activity on the condition that it is conducted for obtaining income and on a continue basis.

¹¹² For further information, see Warburton, “Value Added Tax: Business and the Predominant Concern Test”, *Brit. Tax Rev.* 1995, 539.

¹¹³ Schenk, *Value Added Tax—A Model Statute and Commentary*, p. 32; Schenk and Oldman, *Value Added Tax*, p. 109.

of the two alternatives present administrative problems for taxable persons and for the authorities.

Therefore, the person conducting business and making sales is ordinarily the one who is liable for VAT. In some special sectors, however, this could not be the case and brings in the term, “person treated as [a] taxable person”. For example, with telecommunication services rendered by corporations not resident in the EU, the user of the services is the person liable for the tax, but the nonresident supplier may be jointly and severally liable for the tax.

After reviewing the criteria for being a taxable person, a comparison between “taxable person” and its opposites will lead us to a better understanding of the taxable person. In a VAT system, there are other two concepts that should be noted: exempt persons and non-taxable legal persons. Unlike “taxable person”, there are no express definitions for these two types of subjects in the Directive or any other legal documents. Exempt persons here refers to those who carry on economic activities that are exempt from VAT, such as medical doctors, insurance companies and small enterprises operating below a threshold value of turnover. It does not mean the exempt persons are not taxable in the VAT system, as the purpose or the result of the economic activity is not in consideration in the definition of a taxable person. Thus we can also call them “exempt taxable persons”. And the non-taxable legal persons are referred to the persons, not physical persons,¹¹⁴ who does not carry on an economic activity. Both the taxable persons and the exempt persons are within the regime of VAT, and the exempt persons could be viewed as a special case of taxable persons. The general principle of VAT is that it should be charged on all economic activities throughout the production and distribution chain. Due to the special features of certain sectors, however, in order to combat the tax fraud or tax evasion, or for some other administrative reasons, exemptions come into being in certain circumstances, such as the exemption of small businesses (subject exemption) and

¹¹⁴ A physical non-taxable person is out of the consideration as they could be excluded based merely on the features of taxable persons, such as a normal individual who is employed could be denied as a taxable person as he does not carry on economic activities independently.

exemptions related to educational purposes and so on (sector exemption). One of the main differences between exempt persons and taxable persons is whether they could be entitled to and exercise the right of deduction. Therefore, the next issue that arises is the relationship between the taxable person and the person who is entitled to the right of deduction.

The persons who enjoy the right to deduct input VAT are deemed to be the taxable persons, in other words, the persons who enjoy the right of deduction form part of but not the whole of the taxable persons in a VAT system. One part of the taxable persons are kept out of the deduction system as determined by the legal rules, for example, the above-mentioned exempt persons; another part of the taxable persons of VAT excluded from the deductible regime due to the lack of the other elements required to establish the right of deduction, such as the formal element discussed in the following part. Thus, being a taxable person is a necessary but not a sufficient condition for an individual to be the subject of the right of deduction. For example, according to the VAT statute of Ireland¹¹⁵, exempt persons and non-taxable entities who acquire or are likely to acquire more than €41,000 worth of goods from other Member States in any period of twelve months are obliged to register for VAT in respect of those intra-Community acquisitions. Exempt persons and non-taxable entities below this threshold may elect to register in respect of such acquisitions¹¹⁶. However, registration by exempt and non-taxable persons for receipt of intra-Community acquisitions does not give them VAT deduction rights.

Secondly, there is the term “taxed transactions.” In the first place, these should be “taxable transactions” in the VAT system. Normally, there are four types transactions: supply of goods, intra-Community acquisition of goods, supply of services and importation of goods. The phrase “supply of goods” is given a broad interpretation. Goods are all physical objects, but also include items such as electricity. For VAT

¹¹⁵ Value-Added Tax Consolidation Act 2010 (Number 31 of 2010), chapter 3 “Rules for intra-Community acquisitions”.

¹¹⁶ It should be noted that exempt persons and non-taxable entities acquiring new means of transport or excisable goods must register for VAT irrespective of the value.

purposes, “providing services” concerns all activities that do not include the supply of goods and which are performed for a remuneration. For each situation, specific rules apply to make this determination. Depending on the specifics of the transaction, different rules may even apply for the supply of different types of services or products¹¹⁷. One important factor that determines the above four types of transactions to be taxable transactions is that they are supplied or performed for consideration or remuneration¹¹⁸. For a sale to be subject to VAT there must be a direct connection between the sale and the consideration. In the second place, why is “taxed transactions” used rather than “taxable transactions”? It seems to me that “taxed transactions” contains not only the meaning of “taxable”, but also implies the taxable transactions are already conducted. This is also consistent with the immediacy feature of the right of deduction—the right arises at the time when the tax is chargeable. As Article 63 states: “The chargeable event shall occur and VAT shall become chargeable when the goods or the services are supplied.” “Taxed transactions” is better suited to express the requirement for the establishment of the right of deduction.

Lastly, but not less important, is the requirement for a link between the purchased goods and services and the taxed transactions. That is, the purchased goods and services must be actually invested in the taxed transactions. This should be distinguished from the immediate and direct link between the input tax and the output tax, which is an essential criterion in the determination of the particular individual who could exercise the right of deduction and to what extent the input tax could be deducted¹¹⁹. They are like the two separate manifestations of the same requirement—theoretical and practical. In the test of the immediate and direct link, the time point of the beginning of a business is essential. While the link mentioned here is a factor that might decide whether the right of deduction exists, the mere existence of the purchased goods or services and the taxed transactions carried out by taxable persons is not sufficient to generate the right of deduction. The point that

¹¹⁷ See Articles 14–30 of the VAT Directive 2006 .

¹¹⁸ See, for example, Article 2 of the VAT Directive 2006.

¹¹⁹ See (3) “regulations set by the case law of ECJ to exercise the right of deduction” in part II “The exercise of the right of deduction”.

matters is the real application of the purchased goods or services in the taxed transactions, that is, to be part value of the products (goods or services) of the taxed transactions.

To draw a conclusion, the rule made up by the three elements (as described above) is basic and substantial, as all the other requirements (such as the formal element and territoriality element discussed in the following section) are based on this requirement. In other words: the substantial requirements bring the right of deduction into being, while the formal and territoriality elements decide whether the right could be exercised successfully.

3.1.2 The corresponding requirements in China

In China's current legislation, the relevant provisions concerning VAT are mainly seen in two Regulations: one is the above-mentioned PR-VAT, and the other is the detailed rules of its implementation, "Detailed Rule for the Implementation of the Provisional Regulations of the People's Republic of China on Value-Added Tax"¹²⁰ (hereinafter DRI-VAT). No dedicated articles are related to the requirement of the establishment of the right of deduction. The conditions are contained in Article 1 of PR-VAT, which defines the concept of taxable person for VAT:

All units and individuals engaged in the sales of goods, provision of processing, repairs and replacement services, and the importation of goods within the territory of the People's Republic of China are taxpayers of Value-Added Tax (hereinafter referred to as "taxpayers"), and shall pay VAT in accordance with these Regulations.

Articles 2–10 in DRI-VAT give the detailed implementation rules of this article, among which Articles 2 and 3 concern the topic discussed here. Article 2 explains the concept of goods and definitions of processing, repairs and replacement services. In Article 3, taxable economic activities are defined:

"Sales of goods" as mentioned in Article 1 of the Regulations refers to the transfer of the ownership of goods for any consideration.

¹²⁰ Promulgated by No. 38 Order of the Ministry of Finance on December 25, 1993, amended by No. 50 Order of the Ministry of Finance and State Taxation Administration on November 5, 2008, became effective on January 1, 2009.

“Provision of processing, repairs and replacement services” as mentioned in Article 1 of the Regulations refers to the provision of processing, repairs and replacement services for any consideration. However the provision of processing, repairs and replacement services by the staff employed by the units or individual business operators for their units or employers shall not be included.

“Consideration” as mentioned in these Detailed Rules includes money, goods or any economic benefit obtained from the purchasers.

From the provisions above, the requirements to establish the right of deduction are not provided systematically and separately. In other words, not enough attention is given to the matter of deduction in VAT. But with regard to the important element of economic activity, the requirement to be VAT taxable is clearly given, that is, a consideration must be paid, and like the EU VAT, services supplied by employees are excluded. The problems within the Chinese VAT system reflected here, as far as I am concerned, are in the first place, the provisions in force are not systematically organized and, in the second place, the concrete contents need to be enriched and refined. This is why the ultimate goal of the ongoing VAT reform in China is to improve VAT legislation—to introduce a formal VAT Act, replacing the current Provisional Regulation. For further discussion see Chapter 5, in which concrete suggestions are given for China’s VAT legislation.

3.2 Formal element: the issue of an invoice

3.2.1 The role of the invoice in a VAT system

A VAT invoice is simply a type of invoice that shows certain details of a sale or other supply of goods and services. In the European style credit invoice VAT, a VAT invoice plays a critical role in the functioning of the whole system. A purchaser must have a valid VAT invoice from the supplier in order to reclaim VAT it pays on a sale it makes subsequently. As elaborated above, the integrity of the chain of deduction ensures VAT as an indirect tax which is non-accumulative and enables the principle of neutrality to be realized. The VAT invoice secures the integrity of the deduction chain

as generally no deduction will be allowed without a qualified VAT invoice¹²¹. Therefore, the invoice is indispensable written proof (it could be in paper or electronic form) for a taxable person to exercise its right of deduction. Because of this feature, however, it is also easily used by some persons with intentions to obtain illegal benefits as it is easily falsified and difficult to detect—tax fraud and evasion in VAT is related to the invoice.

A VAT invoice received by one business is the primary evidence for it to recover VAT incurred as input tax. For the tax authority, the VAT listed on a seller's tax invoice can be used to verify the sale being reported on the seller's VAT return. It could also be cross-matched against the buyer's claimed input credit on the same transaction¹²².

3.2.2 Who issues and who receives VAT invoices?

In a taxable transaction, there are at least two participants—transferor and transferee, or seller/supplier and buyer. In principle, the former should give the latter a VAT invoice for any standard-rated or reduced-rated items sold. The rules for a business to issue a VAT invoice vary in respect of the nature of the subjects involved in a specific taxable transaction. With regard to the supplier upstream, almost all VAT systems in the world have the qualification requirement that it must be a VAT-registered person. Only when a person meets the conditions for registration and becomes a general VAT taxpayer, can that person be eligible to issue VAT invoices¹²³. In addition, normally, the invoice should be issued within a time limit. As Article 222 of the VAT Directive 2006 states: “Member States may impose time limits on taxable persons for the issue of invoices when supplying goods or services in their territory”.

In the United Kingdom, only VAT-registered businesses can issue VAT invoices and

¹²¹ But what is important is the substantial taxable transactions recorded on the invoice, rather the invoice itself. Thus there exist the cases in which the deduction of input VAT is granted in the absence of VAT invoice.

¹²² This cross-match usually occurs in taxable transactions before the retail stage. See Schenk and Oldman, *Value Added Tax*, p. 139.

¹²³ As expressed previously, in most VAT systems, there exists a threshold to be a general VAT taxpayer, the business with a turnover more than the amount of the threshold should make a mandatory registration and the small business could make a voluntary registration to be a general taxpayer in some VAT systems.

normally a VAT invoice must be issued within 30 days of the date of the supply¹²⁴. The situation in China is more or less the same, however, the taxable person is divided into two types: the general taxable person and the small-scale taxable person. Only a general taxable person may be qualified to issue a special VAT invoice, pursuant to Article 21 of PR-VAT, which provides:

- (1) Taxpayers selling goods or taxable services shall issue special VAT invoices to the purchasers who ask for them. The sales amount and output tax shall be separately indicated in the special VAT invoices.
- (2) Under any of the following circumstances, no special VAT invoice shall be issued:
 - (a) selling goods or taxable services to individual consumers;
 - (b) selling goods or taxable goods that are free from VAT;
 - (c) selling goods or taxable services by small-scale taxpayers.

As may be observed from the first paragraph, the invoice should be issued on the request of the purchaser, and in addition, based on the content of point (a) of the subsequent paragraph, it is the duty of the seller not to issue VAT invoices to individual consumers. This could be questionable, as it is not reasonable to impose on a taxable person the duty to know whether its purchasers are individual consumers or not.

When it comes to the time limit for the issue of a VAT invoice, detailed regulations are found in the “Provisions for the Use of Special Invoice of Value-added Tax”¹²⁵ (the Provisions). In amending the Provisions, significant changes were made to the time limit for the issue of the invoice. In its previous version, the time limits varied according to the manner in which the taxable transactions were carried out and the ways by which the purchase price was paid¹²⁶. In the amended version, the time limit

¹²⁴ See UK, *VAT Notice 700/21: Keeping VAT Records*, article 4.1 para. 2.

¹²⁵ The “Provisions for the Use of Special Invoice of Value-added Tax”, was initially formulated by State Administration of Taxation on December 27, 1993. It was then amended on October 17, 2006, and came into effect on January 1, 2007.

¹²⁶ See article 6 of the Provision:

The time limit for issuance of special invoices is prescribed as follows:

- (1) If accounts are settled by the methods of advance payment, bills of collection and acceptance, or by authorizing banks to collect payments, it is the day when the goods are dispatched;
- (2) If accounts are settled by the method of payment on delivery, it shall be the day when the payment is received;

is expressed as follows: the special VAT invoice shall be issued in accordance with the time of the occurrence of VAT tax liability. And the precise time of occurrence of VAT tax liability is provided in Article 19 of PR-VAT:

- (1) The time at which the liability to pay VAT arises:
 - (a) for the sale of goods or taxable services, it is the date on which the sales sum is received or the documented evidence of right to collect the sales sum is obtained.
 - (b) for imported goods, it is the date of import declaration of customs.
- (2) The time at which the liability to withhold VAT is the date on which the liability for the taxpayer to pay VAT arises.

Article 38 of DRI-VAT, which gives the detailed explanation of the above article, and its contents are similar to the previous version of the Provision.

Actually, not all the regulations are related to the time limit, but the exact issue time point of a VAT invoice. No space for the flexibility is not practicable here.

With regard to the recipient of VAT invoices, in many VAT systems, a registered person must issue a VAT invoice for all taxable sales, which means the issue of a VAT invoice is mandatory regardless of the nature of the recipient. In other systems, in order to reduce the opportunity of cheating in the VAT invoice, the VAT invoice can be issued only on sales to other registered persons. This means a supplier does not need to issue VAT invoices to customers who are not registered VAT persons. In practice, this rule is usually implemented by the issue of a VAT invoice to customers who ask for one, as the supplier does not usually know if its customers are VAT registered or not and does not have the obligation to check. This rule is typically

(3) If the accounts are settled by the methods of credit sales or hire purchase, it is the day of collection prescribed in contracts;

(4) If goods are sold through consignment agents, it is the day when the bills of consignment sales are received from consignee;

(5) For the transfer of goods from one establishment to another for sale by a taxpayer who maintains two or more establishments and keeps their accounts on a consolidated basis, if Value-Added Tax shall be levied on such goods according to the provisions, it is the day when the goods are transferred;

(6) For goods provided to other units or individual business operators in the form of investment, it is the day when the goods are transferred; or

(7) For goods distributed to shareholders, it is the day when the goods are transferred.

General taxpayers must issue special invoices at the prescribed time, neither earlier nor later.

applied to retailers. A retailer does not need to issue a VAT invoice or receipt unless asked to do so by the customer.

According to general VAT rules, VAT is due by a seller of goods or services. For this reason, the VAT invoice which includes VAT is issued by the seller. However, there is a first exception to this rule—self-invoicing; under this method the customer is able to prepare the invoice and then provides the supplier with the invoice. It could also be called “self-billing”. A prior agreement between the supplier and customer is a precondition for the adoption of the self-invoicing method¹²⁷. Article 224 of the VAT Directive 2006 authorizes the EU Member States to determine the terms and conditions of such prior agreements and of the acceptance procedures between the taxable person and the customer¹²⁸. In Italy, in the case of sales of goods or services made within Italian territory by foreign VAT subjects to Italian VAT subjects/customers, VAT is applied by the Italian resident customer issuing a self-invoice¹²⁹.

3.2.3 The required contents in VAT invoices

As an appropriately issued VAT invoice is crucial to the exercise of the right of deduction, it is a foundation on which the authority makes its determination of the VAT due and the value of any refund, it is particularly important that the precise and unambiguous contents are noted in a VAT invoice. Thus, the central rules for VAT invoices are usually specified in detail in the relevant legislation. In the EU, the VAT Directive 2006 regulates the content of invoices in a separate section¹³⁰. The following information should be contained in a standard VAT invoice:

¹²⁷ Paragraph 1 of Article 224: Invoices may be drawn up by the customer in respect of the supply to him, by a taxable person, of goods or services, if there is a prior agreement between the two parties and provided that a procedure exists for the acceptance of each invoice by the taxable person supplying the goods or services.

¹²⁸ Paragraph 2 of Article 224: The Member States in whose territory the goods or services are supplied shall determine the terms and conditions of such prior agreements and of the acceptance procedures between the taxable person and the customer.

¹²⁹ See Article 17 para. 3 and Article 21 para. 5 of Presidential Decree 633/72 (DPR 633/72).

¹³⁰ Title XI Chapter 3 Section 4 of the VAT Directive 2006.

a. General contents

- ◆ An invoice number which is unique and follows on from the number of the previous invoice;
- ◆ The seller's name or trading name and address
- ◆ The seller's VAT registration number
- ◆ The invoice date
- ◆ The tax point—the time when a sale is treated by tax authority as taking place¹³²—if this is different from the invoice date
- ◆ The customer's name or trading name and address
- ◆ A description of the goods or services

From this list, the general information on a VAT invoice could be classified into three broad categories: information related to the invoice itself; information about the transaction; and information on the subject/s of the transaction. The basic information contained in the VAT invoice is the first line of defense to combat VAT fraud related to the invoice.

b. Information related to item sold

- ◆ Unit price or rate, excluding VAT
- ◆ Quantity of goods or the extent of the services
- ◆ Rate of VAT that applies to the items being sold
- ◆ Total amount payable, excluding VAT
- ◆ Rate of any cash discount

¹³² Due to Article 226 (7) of the VAT Directive 2006, it is the date on which the supply of goods or services was made or completed or the date on which the payment on account referred to in points (4) and (5) of Article 220 was made.

- ◆ Total amount of VAT charged

All the information above is about the particular goods sold or service supplied, either about the nature of the product itself or the related VAT scheme applied.

c. Information about special arrangements, if any

In VAT Directive 2006 Article 226 paragraphs (11)—(15) list some special situations. Most of the special arrangements are determined in the national provisions. For example, in the United Kingdom, if a business issues a VAT invoice that includes zero-rated or exempt items, the invoice shall include the information that shows clearly there is no VAT payable on those items and the total of those values separately.

3.2.4 Simplified VAT invoice

Despite the requirements listed above, a tax invoice may contain less information under certain situations. An example is the regulations prescribed in Article 238 (1) of the VAT Directive 2006:

Member States, in respect of supplies of goods or services in their territory, could simplify a VAT invoice in accordance with conditions after consulting the VAT Committee: (a) where the amount of the invoice is minor; (b) where commercial or administrative practices in the business sector concerned or the technical conditions under which the invoice are issued make it difficult to comply with all the obligations referred to in article 226 and 230.

For example, in the United Kingdom, a registered taxpayer can issue a less detailed VAT invoice if the consideration (including VAT) for the goods sold or services rendered is £250 or less.

However, even in a simplified VAT invoice, there is some information that could not be removed from a VAT invoice, therefore, Article 238 (2) of the VAT Directive 2006 states:

Invoices must, in any event, contain the following information: (a) the date of issue; (b) identification of the taxable person; (c) identification of the type of goods or services supplied; (d) VAT amount payable or the information needed to calculate it.

In principle and in theory, a VAT invoice is an indispensable element in the exercise of

the right of deduction, in practice, however, in view of commercial or administrative costs, it may be simplified or even waived. Nevertheless, the VAT invoice is an intelligent design to ensure the smooth functioning of the deduction mechanism in VAT. It delivers taxpayer compliance motivated by the deduction chain and creates the audit trail for the authority as well. If the right of deduction is the “pivot” in a VAT system, then the VAT invoice is the “lubricant” for the so-called “pivot”.

3.3 The time element

According to Article 167 of the VAT Directive 2006, the right of deduction arises when the deductible tax becomes chargeable. The concept of “chargeable” in the Directive is defined by the distinction between “chargeable event” and “become chargeable” in Article 62:

- “chargeable event” is “the occurrence by virtue of which the legal conditions necessary for VAT to become chargeable are fulfilled”;
- VAT shall become chargeable when the tax authority becomes entitled under the law, at a given moment, to claim the tax from the person liable to pay, even though the time of payment may be deferred.

When it comes to a concrete VAT taxable event, “the chargeable event shall occur and VAT shall become chargeable when the goods or the services are supplied” (Article 63 of the VAT Directive 2006). Thus, the right of deduction arises at the time when the goods or the services are supplied. I refer to it here as the “tax point”. The tax point has significant importance in practice, as it tells subjects to which VAT period the transaction belongs and on which VAT return to put the transaction. In general, the tax point is consistent with the time when the goods or the services are supplied, the intra-Community acquisition of good is made, or the goods are imported. But the exact tax point can vary in practice due to some special circumstances. Take the supply of goods or services as an example, the tax point is decided among the concepts of the “date of supply”¹³³, “date of invoice” and “date of payment” in different situations, as shown in Table 3.

¹³³ For goods, it is the date they are sent, collected or made available (e.g installed in the customer’s house); for services, it is the date the work is finished.

Table 3. Tax point in different situations, based on Articles 63–67 of the VAT Directive 2006.

Situation	Tax point
No invoice needed	Date of supply
VAT invoice issued	Date of invoice
VAT invoice issued 15 days or more after the date of supply	Date of the supply took place
Payment or invoice issued in advance of supply	Date of payment or invoice (whichever is earlier)
Payment in advance of supply and no VAT invoice yet issued	Date payment received

There are always exceptions for certain transactions and in special schemes, in theory, however, the basic principle is that a taxable person obtains the right of deduction at the time when the deductible tax is chargeable. The specific time points decided in practice are just the reflection of the principle in different forms.

Section II The exercise of the right of deduction

1. The triangular relationship between the “protagonists” in the exercise of the right of deduction

A mechanism functions well on the basis that each subject plays its role in a right and reasonable way. In a normal VAT deduction mechanism, the final consumer as a substantial taxpayer is excluded, for apart from the payment (involving the amount of VAT) of the goods supplied or services rendered, no other rights or obligations are related to. Thus, when it comes to the subjects involved in the right of deduction, the following three actually matter: the transferor, the transferee and the tax authority (generally representing the Treasury).

As aforementioned, the right of deduction is a right enjoyed by the taxable person in the process of the determination of tax due. In a credit invoice method VAT system, the exercise of the right of deduction relies on a tax-against-tax methodology; the taxable person calculates their net tax liability for each tax reporting period by the formula: output tax minus input tax credits, in which output tax equals taxable sales multiplied by the tax rate, and input credits consist of VAT on taxable purchases listed on VAT invoices, while allowed only to the extent that the business inputs are used in making taxable sales (as required by the substantial element of the right of deduction). During this calculation process, there exists the so-called “triangular relationship” (three separate relationships being caused by a taxable transaction) between the transferor, transferee and the tax authority. The first one is the relationship between the transferor and the transferee, the former supplies goods or renders services to the latter with a consideration including VAT which will be written on the invoice issued by the transferor. In this relationship, the transferee has the obligation to pay VAT incurred on the transaction to the transferor (as an input VAT in his future taxable transaction), by which the right of deduction arises, and receives a VAT invoice which enables him to exercise the right of deduction when he acts as a transferor in a taxable transaction. The transferor completes the formula of the calculation of his net tax

liability by generating the output tax and could actually exercise the right of deduction when it comes to the end of a tax period, which gives rise to the second relationship—the relationship between the transferor and the tax authority. The transferor exercises the right of deduction to calculate his net tax liability; when the balance is positive, the transferor should pay the tax due to the tax authority. When the difference is negative, namely, the input tax exceeds the output tax, however, the treatment of the difference is either to carry forward the excess deductible amount to the subsequent tax period or to claim a refund of the excess amount but under certain circumstances the difference could just be offset¹³⁴. The tax authority fulfills corresponding “obligations” and under certain conditions it could start up an audit procedure. The last is the relationship between the transferee and the tax authority. In a normal VAT deduction system, there is no direct connection between them in a single taxable transaction, but the transferee actually receives a credit from the authority (the right of deduction arises at the moment when the tax becomes chargeable) which could be deducted from his future taxable transaction as a transferor. All three relationships constitute a cyclic system (a deduction chain) which ends with the final consumer. As the ECJ itself has repeatedly held,¹³⁵ a supplier of goods or services acts as a “mere tax collector for the State and in the interest of the public exchequer”, if one correctly assumes that VAT is a tax ultimately to be borne by the final consumer.

2. The general principles—effectiveness and neutrality—in the exercise of the right of deduction

The exercise of any right should be based on a foundation of certain principles. This is the same in the exercise of the right of deduction. Here I select the two with special influence in the process of the exercise of the right of deduction—the principle of neutrality and the principle of effectiveness—to elaborate.

¹³⁴ As stated in paragraph 2 of Article 183 of the VAT Directive 2006 “... However, Member States may refuse to refund or carry forward if the amount of the excess is insignificant.”

¹³⁵ ECJ, 20 October 1993, Case C-10/92, *Maurizio Balocchi v. Ministero delle finanze dello Stato* [1993] ECR I-5105, para. 25; ECJ, February 21, 2008, Case C-271/06, *Netto Supermarkt GmbH & Co. OHG v. Finanzamt Malchin*, para. 21.

2.1 What is the principle of neutrality?

2.1.1 General characteristics of the principle of neutrality

First, the principle of neutrality is one of the fundamental principles for tax affairs or any other domestic and international affairs, like equity and efficiency. Thus the principle of neutrality, in the first place, has the common characteristics of principle, which manifested in the field of taxation is that it is not only for decoration in tax laws but represents the spirit and the nature of a tax.

Second, like all such principles, the principle of neutrality has significance only together with the provisions of a concrete law. That is to say, it has no meaning alone, only being interpreted by special provision could it be significant. For example, in a VAT system, one of its manifestations is that there should not be any difference between the tax treatment of similar supplies of goods and supplies of services, which is expressed in a series of provisions.

Last, it is also important to emphasize that the principle of neutrality is created by lawmakers artificially, not established through the self-regulation of the market. Therefore, the definition and the detailed demonstrations of the principle of neutrality are not absolute and inflexible, it could be vary in different states and even in different fields within the same state, and be flexible to the change of the objective conditions over time. In addition, deviations from the principle are allowed or tolerated when it is not politically or economically desirable or technically cannot be achieved for some reason.

2.1.2 The meaning of the principle of neutrality in a VAT system

Generally, the definition and the meaning of a concept can be explained by its opposite. From a certain point of view, discrimination is the opposite of neutrality. Thus, put simply, the principle of neutrality means no discrimination, referring to the fact that there is no factor (e.g. taxpayer, situation, country, etc.) being treated more (or less) favorably than the other(s). However, when it is practiced in a certain system, the principle may be given bigger shoes.

Like any concept, the principle of neutrality is only interpreted within the borders of a certain territory, in which region the principle's functions (in a country or an economic integration, etc.), can be properly understood. For VAT and also other general consumption taxes, the principle of neutrality could be divided into internal neutrality and external neutrality.

Internal neutrality in VAT refers to the domestic market, and is sometimes divided into legal neutrality and economic neutrality¹³⁶. In fact, both the reflection of the same phenomenon but viewed from different angles. Legal neutrality in VAT is an approach from the consumer's perspective, which means each consumer should be treated equally in the consumption of identical goods or services. In other words, there should be a correspondence between the tax amount paid and the quantity of consumption on which the tax incurred. To accomplish this, the final tax due is measured on the retail price and, in addition, the tax rate should be the same for identical goods and services. Apparently, gross receipt taxes (GRTs) could not achieve legal neutrality as they are cascade or cumulative taxes (the tax imposed in the upstream will be part of the tax base of the downstream). The total tax burden varies depending on the length of the production and distribution chain. This urges efforts to reduce the length of the chain by vertical and horizontal integration, which results in different tax burdens on identical goods or services. In a VAT system, the tax is charged on the net value added in each procedure of the production and distribution chain, the tax burden borne by the final consumer is equal to the total value-added amount multiple the tax rate, regardless of the number of the stages in the whole chain. Economic neutrality is viewed from the perspective of the economic operation, it requires that the tax should not unduly influence the optimal allocation of the means of production. Certain sectors should not be favorable (unfavorable) choices merely out of the less (more) tax burden. In other words, a business's investment decision should not be largely influenced by the tax factor. The tax burden could be one of the considerations but not the decisive factor. To achieve this requires broadening the tax base by including more

¹³⁶ Ben Terra, *Sales Taxation: The Case of Value Added Tax in the European Community*, Series on International Taxation, no. 8, Kluwer, 1988, pp. 15-19.

types of consumption into the taxable activities and narrowing the scope of specific activities which are treated with the exemption or other special schemes. In addition, a uniform tax rate to the maximum extent is required, as the tax due is decided both by the tax base and the tax rate.

The principles on which the European system of VAT operates are enshrined in the the First Directive¹³⁷ and the VAT Directive 2006. The Preambles to the First Directive state that: “[8]...the replacement of cumulative multi-stage tax systems ... by the common system of value added tax is bound ... to result in neutrality in competition...”. Article 2 of the First Directive, observing the Preambles, states that:

the principle of the common system of value added tax involves the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services, whatever the number of transactions which take place in the production and distribution process before the stage at which the tax is charged. On each transaction, value added tax, calculated on the price of the goods or services at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of value added tax borne directly by the various cost components.

With regard to external neutrality, it is the neutrality in cross-border situations, which refers to the fair competition between domestically produced goods and imports. To accomplish this object, both the import state and export state have certain obligations. For the import state, the tax levied on the goods or services imported should be equivalent to the tax imposed on the similar domestic goods or services, otherwise it would become a protective measure. For the export state, the relief provided to the business should not exceed the domestic tax, otherwise it would be an export subsidy. Both the protective measure and the export subsidy will threaten the fair competition in a single market. In the context of the EU VAT system, neutrality is achieved by the choice of the destination-based¹³⁸ tax levied in the state of consumption. This choice

¹³⁷ On the harmonization of legislation of Member States concerning turnover taxes (67/227/EEC).

¹³⁸ There are generally two principles for the cross-border transactions, the origin principle and the destination principle. Under the former, VAT is paid in the country of origin (where the goods is

was made against the background of economic integration and the efforts to build a single market in the EU. Goods move freely from one Member State to another, but VAT rates are not the same, a VAT based on the origin principle would lead to tax competition and distortion of the single market, as the domestic products and the imports in the same market of a Member State bear different tax amount. To achieve full neutrality under the origin principle “would call for a devaluation of the currency to restore the trade balance and the effects of the tax would be equivalent to a destination-type VAT without exchange rate adjustment”¹³⁹. In addition, from the administrative aspect, to administer an origin-based VAT seems much more difficult than a destination-based VAT. Thus, the EU has made the correct choice which is confirmed by the fact that the World Trade Organization also recommends the use of the destination-based system.

Both internal neutrality and external neutrality are based on a pure and perfect VAT system from an economic perspective, with a sole standard—VAT itself must not be a burden on business engaged in taxed economic activities—without consideration of either the relative cost of the administration and compliance, or the social and political requirements in certain sectors. In practice, the principle of neutrality is constrained by these and other factors. Take the cost of the administration and compliance as an example; the correct collection of the tax relies on both the compliance obligations on business and administrative procedures as they enable the tax authorities to monitor and control the collection process. It is inherent in a VAT system that business bears the burden of compliance with those obligations¹⁴⁰. In the field of VAT, due to its special working system, both the administrative cost for the authority and the compliance cost for the business have always been relatively high. For example, in a study of 125 countries in 2010, the time needed to comply with corporate income tax requirements was found to be 40% less than the time needed for compliance with VAT

produced or sent); under the latter, VAT is paid in the country of the destination of goods and services.

¹³⁹ P. B. Musgrave: *Consumption Tax proposals in an International Setting*, International VAT Monitor, March-April 2001, pp. 56-66.

¹⁴⁰ C. T. Sandford, M. Godwin and P. Hardwick, *Administrative and Compliance Cost of Taxation*, Fiscal Publications, 1989, p. 10.

obligations¹⁴¹. The high compliance cost of VAT must be taken into consideration when we discuss the principle of neutrality, as it may have significant influence on the realization of the principle in a VAT system¹⁴². Each type of taxation generates operating costs in its exercise for business which encompasses all the costs relating to its management, not all the costs are the compliance cost mentioned here, as it also include the costs of actions that are not legally required. The compliance cost in a VAT system here is much narrower, referring only to the costs of meeting the legal VAT requirements. From the working manner of VAT we can see that the compliance obligations run through the whole life of business, from VAT registration to de-registration, especially the costs arising in the deduction chain. Apart from the obvious complicated accounting obligation, a hidden obligation such as a cash flow burden arises when business recover input VAT from the tax authorities only after they have paid their suppliers and when they remit output VAT to the tax authorities before they have received payment from their customer. This cash flow burden could be more frequent for small business with relatively weak finances. Thus, in almost all VAT systems, there exists the exemption mechanism for small businesses which liberates them as well as the authority from the heavy burden of the administration and compliance costs. However, not all the special arrangements in a VAT system , like the exemption for small businesses, are in accordance with the principle of neutrality. Some special arrangements in EU VAT that might infringe the principle of neutrality, in my view, are discussed below.

2.1.3 Special design that might endanger neutrality within EU VAT

As mentioned above, an idealized and perfect neutral VAT is based on the broad tax base, a uniform tax rate and without any special arrangements (e.g. exemptions). But in reality, taxation has more aims other than to raise revenue, such as a tool to redistribute income and an instrument of the macroeconomic policy of the government. Therefore, in some cases, the lawmakers may deliberately depart from

¹⁴¹ S. Symons, N. Howlett and K. Ramirez Alcantara, *The Impact of VAT Compliance on Business*, Price water house Coopers, 2010, p. 7.

¹⁴² At the beginning of the twentieth century, tax compliance cost was not seen as forming part of the economic rationality of taxes. However, that view was soon disputed.

the principle of neutrality to achieve some specific policy goals, such as the application of a reduced rate and exemption either for combating the presumed regressivity of VAT (e.g. food) or satisfying social needs¹⁴³ (e.g. merit/demerit goods). It seems that sometimes the lawmakers prefer to sacrifice the principle of neutrality rather to find out other ways to adjust these political problems. It might be reasonable in some cases but in the situations below it might be questionable.

First, there is the different treatment related to the supplier of goods and services. In theory, there should not be any difference between suppliers. In reality, however, the distinguish treatments exist between the private supplier and the public supplier. Supplies delivered by the private supplier are in principle taxable, while the supplies provided by the public sector are usually exempted, even if the goods or services supplied are the same. This differentiated treatment is confirmed in Article 13 of the VAT Directive 2006, which excludes the state, regional and local government authorities and other bodies governed by public law from the list of taxable persons in respect of the activities or transactions performed by them as public authorities. This treatment might be justifiable in some countries with state-monopolized supplies, but in the present EU, this could not be true, as public organs sometimes supply exactly the same goods or services as the private suppliers, the differentiated treatment in this situation would lead to market distortions. Even paragraph 2 of Article 13 restricts the aforementioned treatment to the condition that the preferential treatment should not lead to significant distortions of competition. The problem is that the restriction is delimited by the word “significant”, which could be interpreted in an endless number of ways. Thus, the principle of neutrality loses its meaning in this provision, and this difficulty has emerged in reality. In the *Feuerbestattungsverein* case,¹⁴⁴ the *Feuerbestattungsverein*, an ordinary VAT taxable person that operated a crematorium, suspected that its competitor, the *Lutherstadt Eislebe*, which was a public body and offered exactly the same services, was entitled to exempt status and thus it could offer

¹⁴³ To encourage the use of some products by imposing lower tax rates and to discourage the use of others, such as alcohol and tobacco products.

¹⁴⁴ ECJ, June 8, 2006, C-430/04 *Feuerbestattungsverein Halle* [2006] ECR I-4999.

its services on a lower price. The tax administration refused to make the tax documentation of a public body public.¹⁴⁵

Second, in addition to the preferential treatment to the public supplier, there is another arrangement for one type of taxpayer created by the lawmakers that might endanger the principle of neutrality. That is the group for VAT taxation. Article 11 of the VAT Directive 2006 provides that:

After consulting the advisory committee on value added tax ..., each Member State may regard as a single taxable person any persons established in the territory of that Member State who, while legally independent, are closely bound to one another by financial, economic and organizational links.

This is an optional provision, and in the subsequent paragraph the provision provides “A Member State exercising the option provided for in the first paragraph, may adopt any measures needed to prevent tax evasion or avoidance through the use of this provision.” From this supplementary provision, we can tell that this arrangement in the first place will give rise to a number of tax avoidance schemes. In almost all countries that implement this provision on groups, the scheme is designed in this way: supplies of goods and services exchanged between the individual members of a VAT group are outside the scope of VAT, whereas the right to deduct input tax is determined on the basis of the tax regime applicable to the transactions performed by the entire group with third parties. This arrangement will, on one hand, give an advantage to the enterprises that are members of the single VAT taxpayer in the market competition and the result resembles vertical integration. On the other hand, this rule may be abused from the opposite direction, which is already reflected in the case law of the ECJ, that is, the original exempt companies seek the deduction of their input VAT that could not otherwise have been deducted by creating groups. All the negative impacts described above are not consistent with the principle of neutrality.

¹⁴⁵The case expressed here is meant to prove the fact that, in reality, it happens that different VAT treatments exist on the same type transaction due to the different nature of subjects who conduct it.

Moreover, one of the essential elements to form a VAT group is that the related companies should be established in the territory of the same Member State, this requirement might be intended to combat tax avoidance, but I do not think it could be really helpful, on the contrary, it is a provision that hinders the EC Treaty freedoms. In summary, the VAT tax group is a questionable institutional design which causes both a potential and real threat to the principle of neutrality.

Last, we come to the highly questionable arrangements in the VAT system—exemptions and multiple rates. Both of them are divergences from the ordinary rules of VAT, but in both cases there is always a justification for the potential deficiency. And in most circumstances, the divergences are unavoidable and to some extent are aimed to achieve substantial neutrality in the VAT system, such as the exemption for small businesses mentioned above. However, in some cases it is extremely difficult to draw the line between transactions treated with exemption or reduced rate and transactions within the ordinary rules of VAT. One of the most controversial exemptions is the one for financial services. In the EU, the supply of financial services to customers inside the EU is exempt from VAT and the supply to customers outside the EU is zero rated¹⁴⁶. This exemption has been widely accepted as inevitable because of the technical difficulty—it is not easy to separate the subject of the transaction and the income it generates as financial transactions are basically money against money. But its significant drawbacks, one of which is the elusiveness of neutrality, are also widely realized and a number of attempts have been made to overcome the technical difficulties. The use of multiple rates is also questionable, as it is desirable from a neutrality point of view that all goods and services are taxed at the same rate. However, almost all EU Member States use multiple rates, which is supported by the invoice-credit mechanism, in order to accomplish some policy goals, such as imposing higher tax on alcohol and tobacco products to discourage consumption of them (demerit goods). This is not a good choice as it sacrifices the neutrality; increasing the consumer prices of these demerit goods seems to be more

¹⁴⁶ This is inferred from the points (a) to (f) of Article 135(1) and Article 169(c), which means the exemption is accompanied by the right for the service provider to deduct input tax.

practical.

The essence of the neutrality principle in the taxation system is that the taxation itself should not distort the decisions of related economic subjects. Compared with the cumulative turnover tax, VAT is more neutral by itself, this was an incentive for the EU to choose it as a harmonized consumption taxation in a single market. And in a VAT system, more significance is put on neutrality, as it is meaningful for both suppliers and final consumers (as they pay VAT). But in practice, the principle of neutrality could not be granted completely in a VAT system, some of the exceptions are reasonable and inevitable, but some are quite questionable and call for change and improvement.

2.2 The right of deduction in VAT and the principle of neutrality

The right to deduct input VAT is derived from general law principles, most importantly, the principle of neutrality. In the history of the adoption and spread of VAT, the pursuit of the principle of neutrality has played a very important role, and it is exactly this purpose that gave birth to the right of deduction. With years of the practice of VAT, neutrality acts not only as a reason for the introduction of the right of deduction, but also by doing so it makes VAT “popular”; the lack of VAT neutrality or imperfect VAT neutrality will lead to market distortions, which goes against its original intention. In addition, in disputes related to the exercise of the right of deduction, the principle of neutrality plays the role as a standard and makes a great deal to grant it to be exercised justified, especially in the ECJ case law. As in the European VAT framework, the national legislation of the diverse Member States is not the greatest problem for the legal integration, but the interpretation of EU law, in the years of practice of the ECJ, the principle of neutrality is gradually becoming a guiding principle of the interpretation and application of the Community law. With regard to the implementation of the provisions about the right of deduction, the principle of neutrality is mostly adopted in VAT fraud cases in which a person who does not legally have the right of deduction attempts to recover the paid VAT. By referring to this principle, the ECJ aims to ensure the correct levying and collection of

VAT. For example, in the *Schmeink* case¹⁴⁷, in order to assess the proportionality of the measures adopted by the Member State to adjust an improperly invoiced transaction under Article 22(8) of the Sixth Directive, the ECJ stated in point 59 of its judgment: “They may not therefore be used in such a way that they would have the effect of undermining the neutrality of VAT, which is a fundamental principle of the common system of VAT established by the relevant Community legislation”. Therefore, the requirement of neutrality generated a VAT system which depends on the deduction mechanism to accomplish the aim of neutrality. At the same time, the principle of neutrality is one of the most important guiding rules in the exercise of the right of deduction.

The right of deduction, in return, guarantees complete neutrality for taxable persons through an immediate and full deduction of all input VAT incurred in connection with economic activities performed. One of the requirements of the principle of neutrality is that the tax on a product or service will not vary just because of the extent or level of integration of a firm, which means VAT itself must not constitute a burden on businesses. This goal is achieved by the credit invoice method VAT through the input tax credit system. In credit invoice method VAT, businesses are charged VAT on the goods or services they buy for their further production, but VAT paid can be deducted (or recovered) in the form of input credit from the output VAT being added to the price of the goods or services they sell to the next supplier. Thus the tax due is collected by the business which, through the exercise of the right of deduction in credit invoice VAT, can shift forward the tax burden to the consumer downstream, and the total tax collected corresponds to VAT paid by the final consumer. In this way, the internal neutrality mentioned above is safeguarded by the deduction chain.

According to the above description, the principle of neutrality and the right of deduction are interdependent and promote each other in VAT system. The former acts as the main reason for the existence of the latter and an indispensable guiding rule in its exercise; the latter in return, guarantees the former is put into practice with a

¹⁴⁷ ECJ, Sept 19, 2000, Case C-454/98, *Schmeink & Cofreth and Strobel* [2000], ECR I-06973.

concrete mechanism.

3. Regulations set by the case law of the ECJ to exercise the right of deduction

The jurisprudence of the ECJ in the realm of VAT is of particular significance for the discussion of fundamental issues regarding this tax, because the court now exercises ultimate judicial authority over 27 national VAT jurisdictions. Moreover, it was the European-style VAT that later spread across the globe, so that the ECJ's judgments are also taken note of in many states that are not members of the EU¹⁴⁸.

3.1 The immediate and direct link

The word “used” in Article 168 of the VAT Directive 2006¹⁴⁹ and its linkage with the taxable activity of the taxpayer seeking a deduction indicates that a cost item must be a component of a taxable supply of goods or services for VAT incurred to be deducted. This linkage is consistently stressed by the ECJ with the expression of “direct and immediate link” as one of its settled principles, which plays the role as one of the requirements to determine whether a taxpayer has the right to deduct a certain amount of the input VAT or not.

3.1.1 What is meant by “used”

As the immediate and direct link is generated mainly from Article 168 of VAT Directive 2006, and exists as a footnote for the general condition, which is expressed in the mentioned article, for a taxpayer to be entitled to deduct input VAT, the comprehensive understanding of the core word “used” is particularly important. Generally, from its literal meaning, the two transactions linked by the word should be actually done, in other words, they have actually happened, especially for the output transactions (the downstream transactions). And in principle, it is true in reality. However, either in the ECJ's case law or in the national law of the Member States, exceptions are tolerated. That is, the link may exist even where goods or services

¹⁴⁸ Michael Lang, Peter Melz and Eleonor Kristoffersson, *Value Added Tax and Direct Taxation: Similarities and Differences*, IBFD, p. 18.

¹⁴⁹ Most of the cases are concerned with Article 17(2)(a) of Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes—Common system of value added tax, as VAT Directive 2006 came into force on January 1, 2007.

acquired with the intention of carrying out a taxable transaction are not in fact so used. Certainly, this affirmation should be made under the condition that neither fraud nor abuse is involved. For example, the United Kingdom is one of the Member States that adopts a broad interpretation of the term “used” in dealing with the right to deduct. Thus, under the UK legislation, VAT is not only deductible to the extent that it is used for taxable transactions but also to the extent that it is to be used¹⁵⁰. This interpretation can also be found in the ECJ case law, such as the deduction arising where a project is speculative or it is aborted and results in the situation that the expenditure could not be related to any business activity that has been or will be carried on. As the ECJ held in the case *Inteercommunale voor Zeewaterontzilting*,¹⁵¹ that initial investment expenditure incurred for the purpose of a business could in principle be regarded as an economic activity. However, this is not unconditional, the tax authorities could require the taxpayer to submit objective evidence to support the intention and can withdraw its entitlement in cases of abuse or fraud. Therefore, the immediate and direct link can be tested and could exist in situations where the output transactions are not actually carried out or even could never be carried out. And derived therefrom, the right of deduction could be authorized in the same situations.

3.1.2 Understanding of the two adjectives: ‘immediate’ and ‘direct’

The existence of a direct and immediate link between a given transaction (the upstream transaction) and the taxable person’s activity (the downstream transaction) as a whole is essential and crucial for the purposes of determining whether the goods and services were used by the latter “for the purposes of the taxed transactions” within

¹⁵⁰ See Value Added Tax Act 1994, § 24(1), which states “Subject to the following provisions of this section, “input tax”, in relation to a taxable person, means the following tax, that is to say—

(a) VAT on the supply to him of any goods or services;

(b) VAT on the acquisition by him from another member State of any goods; and

(c) VAT paid or payable by him on the importation of any goods from a place outside the member States,

being (in each case) goods or services used or to be used for the purpose of any business carried on or to be carried on by him.

¹⁵¹ ECJ, 29 Feb 1996, Case C-110/94, *Intercommunale voor zeewaterontzilting (INZO) v Belgian State* [1996], ECR I-00857. In the case, the applicant reclaimed input tax on the cost of a profitability study re developing processes for turning sea and brackish water into drinking water, but went into liquidation without beginning to trade.

the meaning of Article 168 of VAT Directive 2006.¹⁵²

As a key to the interpretations of the terms used in Article 168 of VAT Directive 2006, the rule “immediate and direct link” was first enshrined in the judgment of *BLP Group plc v. C & E Comrs*¹⁵³. The applicant BLP (a management/holding company which provided services to a group of trading companies producing goods for use in the furniture and DIY industries, namely taxable transactions) claimed to deduct VAT paid on three invoices for professional services supplied to it by merchant bankers, solicitors and accountants respectively, in connection with the sale of shares in the company (the money raised by the sale was used to pay off BLP’s debts). The Court held in paragraph 19,

The use in that provision [Article 17(5) Sixth Directive,] of the words ‘for transactions’ shows that to give the right to deduct under paragraph 2 [Article 17(2) of the Sixth Directive], the goods or services in question must have a direct and immediate link with the taxable transactions, and that the ultimate aim pursued by the taxable person is irrelevant in this respect.

The ultimate aim here refers to the fact that the money raised by the sale was used to pay off BLP’s debts. In the present case, the service that generated the “input tax” was directly related to the sale of shares (exempt transaction), but indirectly to its ultimate aim, thus BLP did not have the right to deduct.

Although the immediate and direct link should be tested in every single case according to its specific situation, there are still some common features, which could be inferred from the use of the two adjectives “immediate” and “direct”, helping us to get a better understanding of the nature of the link.

Fist, what does the adjective word “immediate” indicate? Mainly it represents a temporal requirement which could be understood from two aspects. On one hand, it

¹⁵² The initial provisions contributed to the test was Article 2 of the Sixth Directive and Article 17(2), (3) and (5) of the Sixth Directive.

¹⁵³ ECJ, April 6, 1995, Case C-4/94, *BLP Group plc v Commissioners of Customs & Excise* [1995], ECR I-00983.

means that the time which has elapsed between the two transactions should not be too long. However, the sense of propriety about whether the time elapsed is too long or not should be measured and judged specifically in different cases. On the other hand, does the relationship between the two transactions (the input transaction and the output transaction) have to be one after another? The immediate and direct link presupposes that the expenditure incurred in the transaction to get the goods or services (which were used in the output transaction) formed part of the cost components of the output transactions (which utilize the goods or services acquired). Thus from the point of view of time, those cost components must generally have arisen *before* the taxable person carried out the taxable transactions to which they related. However, from the ECJ's cases, this requirement is not absolute, as implied in another case which also considered the immediate and direct link—the case of *Midland Bank*¹⁵⁴. This case concerned legal expenses incurred *after* an activity had taken place. The taxpayer sought to argue that because the expenses arose from defending a particular claim, the legal expenses were linked to the supplies made from the specific activity giving rise to the claim. The Commissioners of Customs and Excise argued that the legal expenses had no link to the claim but were expenses of the whole business. From the dispute itself, we can infer that the transactions concerned at the two ends of the link are not in an absolutely consecutive relation.

Second, concerning the word “direct”, it could be understood in the spatial sense. From one aspect, the link should not be broken by a third transaction. Although the two transactions linked together are not in an absolutely consecutive relation, they still, in substance, form a causal chain in which no space is offered to a third transaction. From the other aspect, the link must be one between a particular input transaction and a particular output transaction; only under this circumstance is the input tax deductible.

To return to the case of *Midland Bank*, during the hearing the tax authority proposed

¹⁵⁴ ECJ, June 8, 2000, Case C-98/98, *Midland Bank plc v Commissioners of Customs & Excise* [2000], ECR I-04177.

an example which could help us to get a better understanding of the above expression: *A supplies a good to B; on delivery to B, an employee of A's drops the good on passer-by C's foot and injures him. C brings a claim for damages against A. The question then arises whether the legal costs incurred by A in defending itself against C could be seen as a cost component of the supply to B, or whether there is a different link with that supply.* Regarding this example, I am of the same view as the UK tax authority, in that I believe that in such a case the link is too tenuous to be regarded as direct. The services received by B could not be used for a deductible transaction or even be capable of being so used. Moreover, the services provided are not directly related to B's output transaction, but a consequence of making its input transaction (or A's output transaction). Thus, the ECJ stressed in point 30 of its judgment:

However, such a taxable person cannot deduct in its entirety the VAT charged on input services where they have been utilized not for the purpose of carrying out a deductible transaction but in the context of activities which are no more than the consequence of making such a transaction, unless that person can show by means of objective evidence that the expenditure involved in the acquisition of such services is part of the various cost components of the output transaction.

In summary, the two adjectives 'immediate' and 'direct' restrict the link from the aspects of time and space respectively. Usually they cannot be distinguished clearly in specific cases, such as the 'direct' may also bears the meaning that the two transactions should not be very distant in time. Therefore, the two elements should co-operate to determine whether the link exists or not and for further determination about the existence of the right of deduction.

3.1.3 The application of the link in cases where there is no immediate supply

It follows explicitly from the VAT Directive 2006 that the deduction of input VAT depends on a positive link between the incurred expenses and the planned or actually completed taxed output transactions. In theory and in practice, however, the deeper nature of this link constantly gives rise to uncertainty, and thus also uncertainty in

relation to the necessary distinction between direct costs and overhead costs¹⁵⁵. The purpose of this part is to analyze the case law of the ECJ with a view to assessing the status of the relevant test used in some special cases—the cases where there is no immediate supply.

The task of determining an immediate and direct link is relatively straightforward in the case of most ongoing businesses. However, in practice, there are always situations in which the link is more difficult to ascertain. Most of the relevant cases submitted to the ECJ are in a similar situation—where there is no immediate supply. And in this situation there are three types of particular circumstances: the first is where a person plans to undertake a business and has done some preparatory or auxiliary actions (on which VAT was charged) in order to start the business, but in the end that business has to be aborted for any reason¹⁵⁶. In other words, the intended transaction was not carried out in the end. The test of an immediate and direct link in the abortive transactions could be settled by an extent interpretation of the word “used” in Article 168 of the VAT Directive 2006, which has been considered in detail in the previous contents of this section. The input tax is deductible where goods or services are used or to be used for the purpose of any business carried on or to be carried on. Even if in the end the business is never actually carried out, what matters is the intention. As the ECJ held in *Inteercommunale voor Zeewaterontzilting (in liquidation) v. Belgium*, in principle, the initial investment expenditure incurred for the purpose of a business could be regarded as an economic activity and VAT charged on it could be deducted where a tax authority had accepted that a person had declared an intention to commence economic activity and had the status of a taxable person. Thus, the intention to carry out economic activity, to be proved by the registration for VAT, plays a crucial role in the determination of the entitlement of the right of deduction in

¹⁵⁵Dennis Ramsdahl Jensen and Henrik Stensgaard, “The Direct and Immediate Link Test Regarding Deduction of Input VAT: A Consumption-Based Test versus an Economic-Based Test?”, *World Journal of VAT/GST Law*, 3(2), pp. 71-87. The ‘overhead costs’ will be discussed in detail in the following elaboration.

¹⁵⁶ The reason could be circumstances beyond the person’s control, such as in the ECJ Case C-37/95, *Belgium v. Ghent Coal Terminal NV*; or for the reason merely out of economic consideration, as in the above-mentioned ECJ Case C-110/94, *Inteercommunale voor Zeewaterontzilting (in liquidation) v. Belgium*.

the circumstance where the intended transaction was not actually carried out, with the exception of cases of abuse or fraud.

The second is that the intended “output transactions” are not treated as a supply of goods or services by virtue of VAT legislation, particularly the transfer of a business as a going concern (TOGC). Article 5(8) of the Sixth Directive¹⁵⁷ (Article 29 of the VAT Directive 2006) and Article 19 of the VAT Directive 2006 provide that Member States may consider that a transfer of a totality of assets or part of the totality of assets is not a supply of goods¹⁵⁸. Article 6(5) provides that Article 5(8) also applies to services. Thus, the transfer of a business as a going concern is, in principle, neither a supply of goods nor a supply of services by virtue of the VAT legislation. Then the question arises as whether VAT on costs relating to non-supplies can be deducted or not. To answer this, some conceptions should be kept in mind. First, as aforementioned, the two ends in the immediate and direct link are two particular transactions (the upstream transaction which generates the input tax and the downstream transaction which creates the output tax), however, this is the basic understanding in the normal situation. In special situations, such as the hypothetical situation discussed above, the immediate and direct link could be understood extensively, the link could exist between the taxable person’s overhead expenditure (the part in dispute) and the whole of his economic activities or a particular part of the business only. The treatment of the right of deduction (being entitled or not, to what extent the expenditure is deductible) depends on the nature of the link. Second, the conception of overhead input tax and ‘residual’ input tax (which will be elaborated in the section on partial exemption in the following section). Here, put simply, the former consists of all VAT tax charged on the cost of the upstream transactions, and naturally the latter is also included. The latter refers to the tax which relates to both

¹⁵⁷ “In the event of a transfer, whether for consideration or not or as a contribution to a company, of a totality of assets or part thereof, Member States may consider that no supply of goods has taken place and in that event the recipient shall be treated as the successor to the transferor...”

¹⁵⁸ The purpose of the treatment is one of convenience, the option was described as being available “in the interests of simplicity and so as not to overburden the resources of the undertaking”. See the Advocate-General’s opinion at paras 22–24 in *Abbey National plc v Commissioners of Customs & Excise* (C-408/98) [2001].

the taxable (thus could be deducted) and other non-taxable transactions (for example, exempted transactions), the tax charged on the related upstream transaction could not be linked to a particular part of a business.

Based on the concepts expressed above, we turn to the case of *Abbey National plc*,¹⁵⁹ in which the aforementioned question of whether VAT can be deducted on costs relating to non-supplies was considered. In the case, the company was a subsidiary member of a banking group, carried on an assurance business and held a number of rental properties as investments. It sold a tenanted property in respect of which it had elected to waive VAT exemption¹⁶⁰. The sale of the property was treated as the transfer of part of a going concern (it was not a supply for VAT purposes). Thus, the transaction was within the scope of partial exemption, and company reclaimed input tax on its solicitors' fees in relation to the transfer. The two questions were: What was the nature of the solicitors' fees? And to what it was linked, at the other end of the immediate and direct link? For the former question, there was a consensus that the transfer in the present case was not a supply for VAT purposes, the costs incurred by the transferor on services acquired in order to effect that transfer form part of that taxable person's overheads. Concerning the latter, that was the real dispute; did the costs have an immediate and direct link with the whole of his economic activity (in the present case, the transferor undertook both transactions in respect of which VAT was deductible and transactions in respect of which it was exempted) or have a link with a clearly defined part of his economic activities (in the present case, it referred to the sale of the property which the transferor had chosen to waive exemption, thus deductible)? To what extent was the input tax deductible dependent on the decision of

¹⁵⁹ ECJ, February 22, 2001, Case C-408/98, *Abbey National plc v Commissioners of Customs & Excise* [2001], ECR I-01361.

¹⁶⁰Supplies of land and buildings, such as freehold sales, leasing or renting, are normally exempt from VAT. This means that no VAT is payable, but the person making the supply cannot normally recover any of the VAT incurred on their own expenses. However, one can opt to tax land. As under Article 13C(a) of the EC Sixth Directive, 'Member States may allow taxpayers a right of option for taxation in cases of ... Letting and leasing of immovable property'. Now Article 137 of the VAT Directive 2006. These rules were implemented in the section 'Election to waive exemption' of the Schedule 10 of VAT Act 1994. Once you has opted to tax all the supplies you make of your interest in the land or buildings will normally be standard-rated. And you will normally be able to recover any VAT you incur in making those supplies.

the above question. The ECJ ruled that

In principle, such services have a direct and immediate link with the whole of his economic activity. If, therefore, the transferor effects both transactions in respect of which value added tax is deductible and transactions in respect of which it is not, it follows from art 17(5)¹⁶¹ ... that he may deduct only that proportion of the value added tax which is attributable to the former transactions, However, if the various services acquired by the transferor in order to effect the transfer have a direct and immediate link with a clearly defined part of his economic activities, so that the costs of those services form part of the overheads of that part of the business, and all the transactions relating to that part of the business are subject to value added tax, he may deduct all the value added tax charged on his costs of acquiring those services.¹⁶²

Following the decision, the UK tax authority adopted a new policy¹⁶³ as follows: VAT incurred on services that wholly relate to the transfer of part of a business should be treated as an overhead of that part of the business. Where that part of the business produces only taxable supplies, then the VAT incurred is deductible. Conversely, where only exempt supplies are produced then the VAT incurred is not deductible. In instances where both taxable and exempt supplies are produced then VAT incurred is partly deductible, determined by reference to the partial exemption method in place. If the partial exemption method in place fails to achieve a fair and reasonable result then the tax authority may be prepared to approve an alternative method. Thus, we could conclude the treatment of the deduction in the TOGC in the following two tables:

¹⁶¹ Now it is stated in Article 173 of the VAT Directive 2006, which is called “proportional deduction”.

¹⁶² See point 42 of the Judgment of the Case C-408/98.

¹⁶³ See Business Brief 8/2001, July 2, 2001.

Table 4: The test in scenario 1.

The immediate and direct link	Nature of the transactions undertaken by transferor in respect of VAT	Treatments to the input VAT related to the costs in question
The cost in question has a link with the whole of the transferor's business	Both VAT deductible transactions and VAT non-deductible transactions	Proportion deduction (in this situation the input VAT is 'residual')
	Only VAT deductible transactions	Full deduction
	Only VAT non-deductible transactions	No deduction

Table 5: The test in scenario 2.

The immediate and direct link	Nature of the clearly defined part transactions undertaken by transferor in respect of VAT		Treatments to the input VAT related to the costs in question
The costs in question have the link with a clearly defined part of the transferor's business	The general situation	Only VAT deductible transactions	Full deduction
	Situations rarely occur	Only VAT non-deductible transactions	No deduction
		Both deductible, non-deductible transactions	Proportion deduction

The third particular circumstance in which the immediate and direct link is more

difficult to ascertain is the acquisition of a business or shares in a company. This circumstance typically occurs in the relationship between a holding company and its subsidiaries. Analysis of the link is directly related to the status of the holding company, in other words, we must in the first place determine whether the holding company is qualified as a taxable person. The distinction can be found in the cases of *Polysar*¹⁶⁴ and *Cibo*¹⁶⁵: in the former case, the holding company Polysar Investments Netherlands apart from holding shares of its subsidiaries did not take any active part in the management of these subsidiaries and its sole source of income was dividends, namely a pure holding company. So when it sought to deduct VAT incurred in the course of its activities, the Court held that the pure holding company had no right to deduct as it did not have the status of a taxable person for the purpose of VAT, notwithstanding the fact that the holding company belonged to a worldwide group of undertakings¹⁶⁶. The test of immediate and direct link was not applied in this case, but in the latter case, the holding company Cibo Participations SA was not a pure holding company, as besides the dividends it received from its subsidiaries, it also collected management fees from them. In other words, the holding company played an active role in the running of the subsidiaries, such as the supply of administrative, financial, commercial and technical services to its subsidiaries, therefore the holding company, unlike *Polysar*, effected economic activities by itself. The Court reaffirmed its conclusion in *Polysar* that the acquisition of shares in a company is in principle not an economic activity, and as mentioned, in principle, the existence of a direct and immediate link between a particular input transaction and a particular output transaction or transactions in respect of which VAT is deductible is necessary before the taxable person is entitled to deduct input VAT and in order to determine the extent of such entitlement,¹⁶⁷ the immediate and direct link did not exist between the various

¹⁶⁴ ECJ, June 20, 1991, Case C-60/90, *Polysar Investments Netherlands BV v Inspecteur der Invoerrechten en Accijnzen* [1991], ECR I-03111.

¹⁶⁵ ECJ, September 27, 2001, Case C-16/00, *Cibo Participations SA v Directeur régional des impôts du Nord-Pas-de-Calais* [2001], ECR I-06663.

¹⁶⁶ See point 17 of the Judgment of the ECJ Case C-60/90, *supra* 163.

¹⁶⁷ Both enshrined in paragraph 24 of the judgment in *Midland Bank*, and paragraph 26 of the Judgment of the *Abbey National* case.

services purchased by a holding company in connection with its acquisition of a shareholding in a subsidiary and any output transaction or transactions in respect of which VAT is deductible. However, similar to the situation in a TOGC, when there is no immediate and direct link between a particular VAT taxable upstream transaction and a particular VAT taxable downstream transaction, the link could be tested between the overhead costs and the business as a whole. Therefore the Court concluded in the *Cibo* case: “expenditure incurred by a holding company in respect of the various services which it purchased in connection with the acquisition of a shareholding in a subsidiary forms part of its general costs and therefore has, in principle, a direct and immediate link with its business as a whole”¹⁶⁸. Therefore, the treatment of the right to deduct VAT in the acquisitions of shares in a company falls into the above tables.

To draw a conclusion for the test of the immediate and direct link in this part, first the link is generated from Article 168 of the VAT Directive 2006 and mainly as an interpretation of the word “used” which links the two ends together. That is, the deduction of input VAT depends on a positive link between the expenses incurred and the planned or actually completed taxed output transactions. Second, the right application of the test is based on firstly the correct understanding of the two adjectives ‘immediate’ and ‘direct’, which restrict the nature of the link from the temporal and spatial angles respectively. In principle, the link should be tested between two particular transactions performed by a taxable person, however, in some special cases, especially in the cases where there are absence of one end of the chain—no immediate supply, or in other words, no VAT taxable output transactions—because of the situations beyond the control of the subjects or just by virtue of the legislation. Theoretically, there is no need to conduct an “immediate and direct” test in these cases, however, this may result in extra economic burden for the taxpayer and thus infringe the principle of neutrality. Therefore, on one hand, an extensive interpretation of the word “used” is adopted in the cases where the intended output transactions are aborted; on the other hand, according to the case law, the test

¹⁶⁸ See point 35 of the Judgment of the *Cibo* case, supra 164.

of the immediate and direct link is extended to the overhead costs and the whole of a business or a particular part of a business.

3.2 The substantial element outweighs the formal element (substance over form)

3.2.1 General remarks

This part generally focuses on cases concerning the right of deduction in the situation without an properly issued invoice.¹⁶⁹

According to the VAT Directive 2006 and the regulations in most of the Member States, the right of deduction can only be established on the base of a qualified VAT invoice. The need to retain an invoice is a strict requirement within the EU legislation and is seen as essential to prevent fraud. This is reflected in two aspects. First, under normal circumstances, an invoice is considered as evidence to prove that the related input tax has been incurred and the input tax could not be deducted lawfully unless there is a VAT invoice, as ruled in Article 178 of the VAT Directive 2006. Second, the subject who is written on the invoice will in principle be liable to pay that VAT, which is implied in Article 203 of the VAT Directive 2006: VAT shall be payable by any person who enters the VAT on an invoice. The requirement is consistent with the formal element required for the establishment of the right of deduction. However, it should be noted that, in practice, there are many cases in which a person is entitled to deduct the input tax even where a VAT invoice has not been issued or retained. This entitlement may accrue either because of the possession of other evidence or the completion of the mentioned substantial element¹⁷⁰—a supply has been made or received. This is indicated in the title of this section—the substantial element outweighs the formal element. This is mainly manifest in the following aspects: the entitlement of the right of deduction without an invoice; the entitlement of the right of

¹⁶⁹ In this thesis, “without a properly issued invoice” can be divided in the following situations: no invoice exists; an invoice contained incorrect information; an invoice without full information.

¹⁷⁰ The Member States may grant their tax authority (Customs and Excise) discretion for some special situations. For example, in the United Kingdom, regulations made under VAT Act 1994, § 24(6)(a) ‘... to be treated as his input tax only if and to the extent that the charge to VAT is evidenced and quantified by reference to such documents as may be specified in the regulations (these are detailed in Value Added Tax (general) Regulations 1995/2518) or the Commissioners may direct either generally or in particular cases or classes of cases.’

deduction with a less detailed invoice or other types of invoice (this could be proved by the allowance of the issue of a simplified invoice); the adjustment of deduction because of an improperly issued invoice;¹⁷¹ rejection of the right of deduction even there is a full invoice, which means, holding a VAT invoice does not automatically entitle a person to reclaim VAT if a supply has not been received. Certainly, these exceptional treatments could not deny the principal rules for the establishment of the right of deduction, as confirmed by the Advocate General's opinion in the case *Finanzamt Gummersbach*¹⁷²; the need for a tax invoice to allow input tax to be deducted as a strict requirement.¹⁷³

3.2.2 The entitlement of the right of deduction without an invoice

The situation in which there is no invoice can be divided into two different circumstances. The first is where there are duplicate or substitute documents which could act as an invoice and be allowed by the tax authority¹⁷⁴. This could be the case in which, for instance, there is only one invoice to support payments of rent for twelve months in the supply of a lease. This type of circumstance is beyond the discussion here. The other circumstance is where the supply has been carried out or is to be carried out even if no invoice is issued. And this is exactly what we are talking about—the substantial element outweighs the formal element.

To expand the discussion of this part and to provide an example of the latter type of circumstance, I refer to the English case *Croydon Hotel & Leisure Co Ltd v Commissioners of Customs and Excise*¹⁷⁵. The issue in this appeal was the tax on a sum of money which was paid by the appellant to the Holiday Inns hotel company in order to terminate a management agreement between them. Holiday Inns took the view that the payment was compensation for loss of income which was outside the

¹⁷¹ Mainly concerns the situation in which the amount of tax invoiced exceeds the tax due.

¹⁷² ECJ, April 1, 2004, Case C-90/02, *Finanzamt Gummersbach v Gerhard Bockemühl* [2004], ECR I-03303.

¹⁷³ In fact, the Court did not adopt the opinion, but this is still an exception, as the fact of the case is: a recipient of services is also the person liable to pay VAT on those services and to whom that tax has been charged.

¹⁷⁴ See for example, VAT Regulations, 1995 reg 29(2), SI 1995/2518.

¹⁷⁵ *Croydon Hotel & Leisure Co Ltd v Commissioners of Customs and Excise*, VAT and Duties Tribunals [1997] V & DR 254, May 21, 1997.

scope of VAT and refused to supply a tax invoice. The appellant sought the advice of the Croydon VAT Office who expressed the view that the termination agreement was a taxable supply and on 4 September 1991 the Croydon VAT Office wrote to the appellant to say that alternative evidence would be acceptable to support the claim for input tax. In its return for the accounting period ending on 30 September 1991 the appellant deducted input tax on the termination payment without an invoice. However, on 3 June 1993 the decision of the VAT Tribunal in *Holiday Inns (UK) Ltd v The Commissioners of Customs and Excise*¹⁷⁶ led the tax authority to recover the input tax previously claimed by the appellant as the tribunal decided that the payment made by the appellant to Holiday Inns was not consideration for a supply of services. From the perspective of the causes of the entire case, either the initial entitlement of the right of deduction made by the authority or the subsequent withdrawal of the deducted input tax, we could infer a conclusion that the fact whether there was a taxable supply was a determinant element in the establishment of the right of deduction. Thus, the tribunal in this case held that “the first issue for determination in the appeal is whether the termination of the management agreement was a supply of services”¹⁷⁷ but without any consideration of the invoice.

3.2.3 The adjustment of deduction because of an erroneously issued invoice

In other cases, the VAT is overcharged by the supplier as the invoice is erroneously issued. The discussion is restricted to the normal deduction mechanism in which the supplier issues an invoice to its receipt and is liable to the tax authority to pay the tax due, while the invoice receipt (the purchaser) gets its right of deduction of the paid input tax, without consideration of the system of reverse charge or any other special arrangements in the VAT regime.

For the sake of clarity, the concepts used here should be delimited first. In the first

¹⁷⁶*Holiday Inns (UK) Limited v The Commissioners of Customs and Excise*, Manchester VAT Tribunal MAN/91/1475 (Transcript), June 3, 1993.

¹⁷⁷ The Tribunal made its conclusion that “the Appellant is not deprived of its right to deduct the input tax even though Customs and Excise are not now entitled to claim the output tax from the supplier, Holiday Inns” as it held, the termination payment paid by the Appellant was the consideration for the placing of the hotel at the disposal of the Appellant, which was a supply of services within the extended meaning of that term as it was a transaction which was not a supply of goods.

place, “an erroneously issued invoice” refers to an invoice incorrectly issued by the supplier which results in its customers being overcharged VAT and VAT being overpaid to the tax authority. The causes of the error could be various, for instance, the mis-classification of the nature of the supply in question¹⁷⁸ or merely because of the incorrect calculation of the amount of the VAT due. The reason could be an initial misinterpretation of the VAT rules. In the second place, the “adjustment” in the title means the correction of the formal debt which is recorded on the invoice according to the material debt based on the transaction actually carried out. In other words, the formal VAT debt is VAT that becomes payable solely out of the ground that VAT was mentioned on an invoice, regardless of all the material facts (such as, whether a taxable transaction was carried out, a chargeable event took place or VAT became chargeable). A VAT obligation generated Article 203 of the VAT Directive 2006 is one example of a “formal VAT debt”¹⁷⁹. A false “formal VAT debt” might be caused by a mere administrative mistake by the issuer of the invoice or by an initial misinterpretation of VAT rules. In contrast to the formal VAT debt, the “material VAT debt” only arises in the conditions that a taxable transaction was carried out, the chargeable event occurred and the tax became chargeable, which is inconsistent with the regulations set out in Article 2, and Articles 62–71 of the VAT Directive 2006. Finally, as the situation under scrutiny here involves three parties—the VAT tax authority, the taxable person making a “supply”¹⁸⁰ and issuing an invoice with respect to the supply, and the recipient of a supply (who receives the invoice for that supply)—the difference between the “formal VAT debt” recorded on the invoice and the “material VAT debt” could have different appellations. The first two terms may be defined between the supplier and the recipient, I choose to use the “overcharged VAT”¹⁸¹ and “unduly paid VAT”¹⁸² respectively to indicate the excess VAT charged

¹⁷⁸ This may be the case when it was incorrectly considered that the supplies were taxed at the standard VAT rate, an exemption did not apply, the supplies were inside the scope of VAT, etc.

¹⁷⁹ In this respect, it must be noted that Art. 203 simply states that VAT entered on an invoice shall be ‘payable’; it does not define a separate chargeable event or a chargeability of VAT with respect to VAT that was entered on an invoice.

¹⁸⁰ The ‘supply’ here may not, in substance, consistent with VAT taxable supplies according to the VAT legislation, but is wrongly treated as a taxable supply.

¹⁸¹ Swinkels uses the term “unlawfully charged VAT” to refer to such a charge. See J. J. P. Swinkels,

by the supplier on his invoice to the customer and the recipient's payment of the excess VAT to the supplier. As to the terms used between the supplier and the tax authority, I choose the term "overpaid VAT"¹⁸³ to refer to VAT paid by the supplier to the tax authorities (the formal VAT debt) which was more than was materially due and the term "over-collected VAT"¹⁸⁴ corresponding to the excess amount collected by the tax authority from the supplier. The above four terms used indicate the same object—the balance between the material VAT debt and the formal VAT debt—, but refer to the different parties involved and the relative interaction directions in one relationship¹⁸⁵. They can be expressed as in the diagram (Figure 3) below:

"Remittance of Unlawfully Charged VAT under EU Law", *International VAT Monitor*, 2008 Jul./Aug., pp. 253–261. Since this article deals with the consequences of progressive insight on the application of the material VAT rules, therefore, the term 'unlawfully charged VAT' may have the connotation of the supplier deceitfully charging too much VAT on his invoice. I prefer the more neutral term 'overcharged VAT'.

¹⁸² Attention should be paid to a practical situation, the parties had agreed upon a price including VAT but yet less VAT appears to apply to the supply than was applied to it, as the hereby circumstance discussed. The unduly paid VAT still applicable regardless of whether the parties had previously agreed upon a price excluding or including VAT, though the subsequent 'adjustment' to them may not be identical.

¹⁸³ According to the case law of the ECJ, the Court applied 'taxes paid but not due' referring to VAT that should not have been paid by the supplier. See, for example, ECJ, Dec 15, 2011, Case C-427/10, *Banca Antoniana Popolare Veneta SpA v Ministero dell'Economia e delle Finanze and Agenzia delle Entrate* [2011], ECR I-13377, at 22.

¹⁸⁴ According to the case law of the ECJ, this is what the Court means when it uses the phrase 'VAT levied by a Member State contrary to the rules of Union law'. See, for example, ECJ, April 10, 2008, Case C-309/06, *Marks & Spencer plc v Commissioners of Customs & Excise* [2008], ECR I-02283, at 35.

¹⁸⁵ For further information on the four terms expressed, see, Ad van Doesum, 'A Law of Counteracting Forces: The Reimbursement of Overcharged, Unduly Paid, Overcollected and Overpaid VAT', *EC Tax Review*, 2013, 22(3): pp. 131–144.

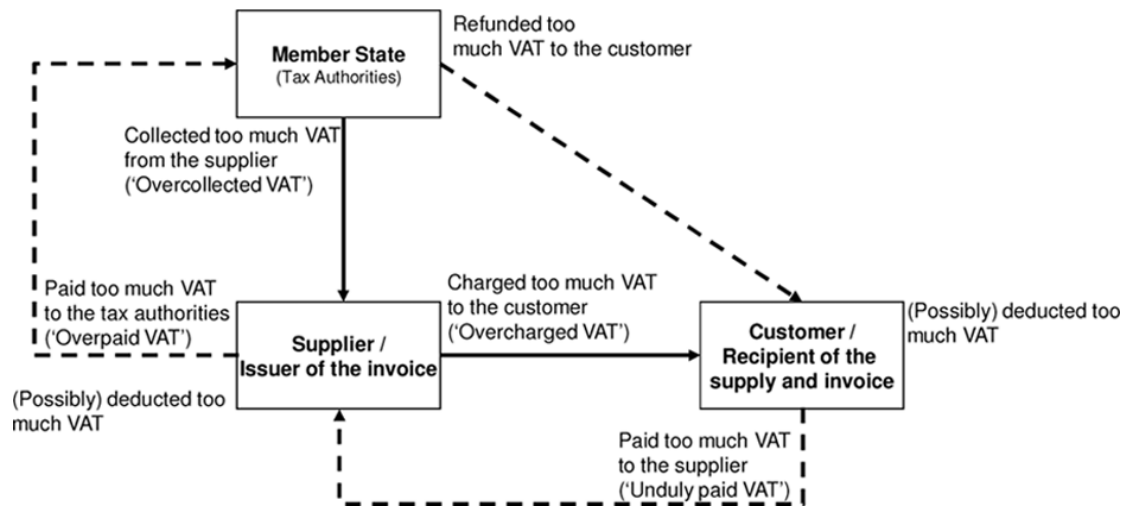


Figure 3. Parties involved and the definitions used.

According to the case law of the ECJ, in the cases where VAT has been overcharged (over-collected, unduly paid or overpaid), the most obvious result is the loss of the tax revenue from both the supplier and the recipient. For instance, a supply being treated as a taxable supply previously and being taxed in the normal way is found to be an exempt supply, then the supplier may calculate his pro rata right of deduction at a higher percentage than he ought to and the recipient may have deducted too much input VAT than he deserved to as long as he has the right of deduction. And the situation will be the same in which a lower tax rate should have been applied. Thus, from the perspective of the guarantee of the tax revenue of the Member States, Article 203 of the VAT Directive 2006, aiming to prevent the risk of any loss in tax revenue, provides that VAT shall be payable by any person who enters VAT on an invoice¹⁸⁶. Thus the motives or intentions of the person mentioning VAT on an invoice are not taken into consideration in this respect. In the light of the foregoing, both the wording and scope of Article 203 of the VAT Directive 2006 are broad enough to cover the above-mentioned situations in which VAT was overcharged by an invoice which is later proved to have been erroneously issued¹⁸⁷. However, in the well-established case

¹⁸⁶ In the Explanatory Memorandum to the Sixth Directive, it was mentioned that: Any person who mentions value added tax on an invoice must be considered liable for payment of the tax, by reason of the right to deduction which the issue of the invoice may vest in the recipient if he is a taxable person. See, Explanatory Memorandum to the proposal for a Sixth Directive of June 20, 1973, COM (73)950, at Art. 21.

¹⁸⁷ The EU VAT Directives do not contain any provisions relating to the adjustment by the issuer of

law of the ECJ¹⁸⁸ and in some of the Member States' national legislation,¹⁸⁹ erroneously issued invoices should be adjusted based on a series of conditions. Therefore it is worthwhile to make a study of the conditions under which VAT erroneously recorded on an invoice can be adjusted. Here, the distinction between the two aspects or phases in the course of adjustment should be noted—a refund of over-collected VAT (between the tax authority and the supplier) and the refund of overcharged VAT (between the supplier and the recipient). On the one hand, in the light of Article 203 of the VAT Directive 2006, the issuer of an invoice is liable to pay VAT entered on that invoice even if there is no taxable transaction, which makes it seem unnecessary to adjust the over-collected VAT caused by an erroneous invoice between the tax authority and the supplier. On the other hand, according to Articles 63 and Article 167 of VAT Directive 2006, the establishment and exercise of the right of deduction of the recipient (of the invoice in question) are merely based on the transactions actually carried out and the amount to be deducted is limited solely to tax corresponding to a transaction subject to VAT¹⁹⁰. This has been confirmed by the case law of the ECJ, as it upheld a general rule that the right to deduct VAT invoiced is linked to the actual performance of a taxable transaction¹⁹¹ and the exercise of that right does not extend to VAT which is payable, under Article 203 of the VAT Directive 2006, solely because it is entered on the invoice (see, inter alia, Case C-342/87 *Genius*

improperly invoiced VAT. See, ECJ, Sept 19, 2000, Case C-454/98, *Schmeink & Cofreth AG & Co. KG v Finanzamt Borken and Manfred Strobel v Finanzamt Esslingen* [2000], ECR I-06973, at 48. "... it should be observed that the Sixth Directive does not contain any provisions relating to the adjustment by the issuer of the invoice of VAT which has been improperly invoiced. The Sixth Directive merely defines, in Article 20, the conditions which must be complied with in order that deduction of input taxes may be adjusted at the level of the person to whom goods or services have been provided."

¹⁸⁸ The ECJ held that VAT which has been improperly invoiced can be adjusted because of the principle of neutrality in VAT, as without the adjustment, the overcharged VAT (in which contain the non-deductible amount) would lead to the cascading of tax on the condition that the recipient of the invoice carried out a taxable transaction and VAT on this transaction will be calculated over an amount including (non-deductible) VAT. This has been repeatedly stressed in the cases, such as, ECJ, Dec. 13 1989, Case C-342/87, *Genius Holding BV v Staatssecretaris van Financiën*, [1989] ECR I-04227, at 18; Case C-454/98, *Schmeink & Strobel*, supra n. 186, at. 58.

¹⁸⁹ For example, in Bulgarian law, under Article 70(5) of the Law on value added tax (*Zakon za danak varhu dobavenata stoynost*, DV No 63 of 4 August 2006), "[a] right to deduct input VAT cannot be claimed if that VAT has been improperly invoiced".

¹⁹⁰ See, ECJ, Jan 31, 2013, Case C-642/11, *Stroytrans EOOD v Direktor na Direktsia*, [2013] ECR not yet published, at 42.

¹⁹¹ See Case C-536/03 *António Jorge Leal v Fazenda Pública* [2005] ECR I-4463, paragraphs 24 and 25.

Holding BV v Staatssecretaris van Financiën [1989] ECR 04227, paragraphs 13 and 19, and Case C-35/05 *Reemtsma Cigarettenfabriken GmbH v Ministero delle Finanze* [2007] ECR I-2425, paragraph 23)¹⁹². Therefore, the contradiction between the above two aspects comes into being as they are based on the same invoice, and the erroneously issued invoice should be corrected by the initial issuer. This is, in fact, a conflict between the *ratio legis* of Article 203 of VAT Directive 2006—to prevent the risk of any loss in tax revenues—and the other tax principles (the principle of neutrality, proportionality and economic efficiency, etc.). The resulting balance between them is that the latter overcomes the former, as it is settled case law that the principle of the neutrality of VAT requires that VAT which is due on the basis of Article 203 can be “adjusted”¹⁹³. This victory is not absolute, as the word used here is “can” rather than “must”. We could infer, thus, on one hand, the correction of the erroneously issued invoice must be subject to certain conditions, on the other hand, the principle that the substantial element outweighs the formal element is applied here conditionally rather than absolutely.

When it comes to the detailed conditions for the adjustment of an erroneous invoice, it is up to the Member States to set the regulations on correction of any VAT erroneously invoiced in their internal legal systems, as the VAT directives of the EU contain no provision with regard to this aspect. But there are some common rules established by the ECJ which should not be violated by the relevant regulations of the Member States. From the cases I have studied, these common rules can be divided into two categories: first, the basic principles—the conditions under which a Member State allows for adjustment of the improperly invoiced VAT shall not have the effect of undermining the principle of neutrality,¹⁹⁴ and they must adhere to the principles of

¹⁹² So far as concerns the treatment of VAT that has been improperly invoiced in the absence of a taxable transaction, it follows from VAT Directive 2006 that the two traders involved are not necessarily treated identically in so far as the issuer of the invoice has not corrected it. See, case *Stroytrans EOOD*, supra 189, at 41.

¹⁹³ See: *Genius Holding*, supra n. 187, at 18; *Schmeink & Strobel*, supra n.186, at. 58.

¹⁹⁴ See ECJ, 18 Jun. 2009, Case C-566/07, *Staatssecretaris van Financiën v Stadeco BV*, [2009] ECR I-05295, at 39: “... They may not therefore be used in such a way that they would have the effect of undermining VAT neutrality, which is a fundamental principle of the common system of VAT established by the relevant Community legislation...”

equivalence and effectiveness¹⁹⁵. Second, the detailed requirements for the correction of the invoice have both positive and negative perspectives. From the positive perspective, two requirements were put forward by the ECJ, firstly, the person who issued the invoice (also who would make the correction of the invoice) should prove that he acted in good faith¹⁹⁶. Secondly, the ECJ added that the adjustment should be made under the condition that the issuer of the invoice has in sufficient time wholly eliminated the risk of any loss in tax revenues (which is consistent with the *ratio legis* of Article 203 of VAT Directive 2006)¹⁹⁷. From the negative perspective, the ECJ has ruled that adjustment in respect of improperly invoiced VAT cannot be dependent upon the discretion of the tax authority¹⁹⁸. In addition, according to the settled case law, the over-collected VAT in general should be repaid to the supplier from the tax authority based on the adjustment of the erroneously issued invoice¹⁹⁹. In my opinion, the rule that a taxable person can in principle reclaim VAT he overpaid to the tax authority can also be inferred from Article 2 of the VAT Directive 2006, as it indicates the principle that VAT must be exactly proportional to the price of the goods and services. The adjustment of the invoice is restricted by a series of conditions and the reimbursement of the over-collected VAT is constrained by one exception, under the conditions that (1) the charge has been borne in its entirety by someone other than the taxable person, and (2) the reimbursement of the charge would constitute unjust enrichment of the taxable person²⁰⁰.

¹⁹⁵ See ECJ, Mar. 15, 2007, Case C-35/05, *Reemtsma Cigarettenfabriken GmbH v. Ministero delle Finanze*, [2007] ECR I-02425, at 37: "... those conditions must observe the principles of equivalence and effectiveness, that is to say, they must not be less favorable than those relating to similar claims founded on provisions of domestic law or framed so as to render virtually impossible the exercise of rights conferred by the Community legal order (see, inter alia, Case C-30/02 *Recheio v Cash & Carry* [2004] ECR I-6051, paragraph 17, and Case C-291/03 *MyTravel* [2005] ECR I-8477, paragraph 17).

¹⁹⁶ See: *Genius Holding*, supra n. 187, at 18.

¹⁹⁷ *Schmeink & Strobel*, supra n. 186, at 58. See also: ECJ, 6 Nov. 2003, Joined Cases C-78/02 to C-80/02, *Elliniko Dimosio v. Maria Karageorgou* (C-78/02), *Katina Petrova* (C-79/02) and *Loukas Vlachos* (C-80/02), [2003] ECR I-13295, at 50; and *Stadeco*, supra n. 193, at 37.

¹⁹⁸ See: *Schmeink & Strobel*, supra n. 186, at 68, 70; and *Stadeco*, supra n. 193, at 38.

¹⁹⁹ Opinion of Advocate-General Mazák, 15 Sep. 2011, Case C-427/10, *Banca Antoniana Popolare Veneta SpA v. Ministero dell'Economia e delle Finanze and Agenzia delle Entrate*, at 13: "To my mind, it can be inferred from the case-law that European Union law places Member States under a general obligation to make it possible for VAT paid but not due to be refunded, and for individuals to enforce the corresponding rights...".

²⁰⁰ See, ECJ, Oct. 2, 2003, Case C-147/01, *Weber's Wine World Handels-GmbH and Others v.*

When it comes to the right of deduction of input VAT, the problem arises “does the right of deduction of the input VAT provided in the VAT Directive 2006 apply to the input tax which is due solely because it is mentioned on the invoice?”. This is exactly the question which was asked by the appellant in the case *Genius Holding BV*²⁰¹. In that case, the Inspector of Taxes imposed on Genius Holding BV an adjustment of the taxable amount for the purposes of turnover tax on the ground that the plaintiff wrongly deducted tax invoiced to it by one of its subcontractors because the tax in question had been charged in error and could not therefore be deducted. The judgment of the ECJ was completely contrary to the opinion of the Advocate General. The Court held that from the background²⁰² of the drafting of Article 17(2)(a) of the Sixth EU VAT Directive²⁰³ or the other provisions of the Sixth Directive,²⁰⁴ Article 17(2)(a) should be interpreted as: the right to deduct may be exercised only in respect of taxes actually due, that is to say, the taxes corresponding to a transaction subject to VAT or paid in so far as they were due. In order to ensure the application of the principle of neutrality of VAT, it is for the Member States to provide in their internal legal systems for the possibility of correcting any tax improperly invoiced where the person who issued the invoice shows that he acted in good faith²⁰⁵.

In summary, the general treatment method inferred from the ECJ case law under the circumstance that a VAT invoice has been erroneously issued—to make an adjustment of a VAT invoice according to the transaction actually carried out under certain conditions—reflects the principle that the substantial element outweighs the formal element to some extent but not completely. This is the result of the interaction

Abgabenberufungskommission Wien, [2003] ECR I-11365, at 94.

²⁰¹ See *Genius Holding*, supra n.187.

²⁰² In drafting Article 17(2)(a), the Council departed both from the wording of Article 11(1)(a) of the Second Council Directive of 11 April 1967 (Official Journal, English Special Edition 1967, p. 16) and from that of Article 17(2)(a) of the Commission's proposal for a Sixth Directive (Official Journal C 80, 5.10.1973, p. 1), provisions under which the taxable person was entitled to deduct any tax invoiced to him in respect of goods or of services supplied to him. See, *Genius Holding*, supra n.117, at 12.

²⁰³ Article 168(a) of VAT Directive 2006.

²⁰⁴ According to Article 18(1)(a), to exercise his right to deduct, the taxable person must hold an invoice, drawn up in accordance with Article 22(3)(b), which requires the invoice to state clearly the price exclusive of tax and the corresponding tax at each rate as well as any exemptions. As well as the requirement of adjustment in Article 20(1)(a). See, *Genius Holding*, supra n.187, at 15.

²⁰⁵ See, *Genius Holding*, supra n.117, at 18.

between various principles in the tax field and the ultimate purpose of the tax (to ensure the fiscal revenue).

3.2.4 Denial of right of deduction even where there is a full invoice

Contrary to the normal rule of the right of deduction in VAT, the situation to be discussed here relates to the fact that in practice holding a VAT invoice does not automatically entitle a person to reclaim VAT (if a supply has not been received). The cases discussed above could be contained in this situation as the adjustment of the deduction of the input VAT amount could be seen as partly a denial of the right of deduction. Where the amount of VAT charged is not the correct amount, only the amount that should have been charged is deductible, even if the incorrect amount is shown on the invoice. Apart from this, refusing the right of deduction despite the holding of a full invoice is typically manifested in VAT tax fraud cases.

The most prominent type of tax fraud in VAT is the so-called “carousel fraud” (which will be elaborated in the following part of this section). In carousel fraud cases, the right of deduction is denied on the grounds that the “transactions” in the supply chain within a carousel fraud are outside the scope of VAT as they lack “economic substance”. The dispute might arise from an innocent trader in a carousel fraud who has no knowledge of and is not capable of knowing the fraudulent intention in the supply chain. The central consideration in such a dispute is that the entitlement of a trader to credit for a payment in respect of VAT under a transaction should be judged by reference to the particular transaction to which the trader was a party or by reference to the totality of transactions, including subsequent transactions, making up a circular chain of supply of which the particular transaction forms part. Thus the key factor is the substantial nature of the transaction involved, which per se reflects the regulation being discussed here—the substantial element outweighs the formal element. The ECJ’s position is presented in joined Cases C-354/03, C-355/03 and C-484/03²⁰⁶. In all of these cases, the two most important common facts that could not

²⁰⁶ ECJ, 12 Jan 2006, joined cases C-354/03, C-355/03 and C-484/03, *Optigen Ltd (C-354/03), Fulcrum Electronics Ltd (C-355/03) and Bond House Systems Ltd (C-484/03) v Commissioners of*

be challenged were: (1) there was a carousel fraud; (2) the applicants were innocent parties who were not involved in and had no knowledge of or reason to have knowledge of that fraud. The Court's view was consistent with the Opinion of the Advocate General, which observed (point 27), "Each transaction must therefore be regarded on its own merits. Consequently, the character of a particular transaction in the chain cannot be altered by earlier or subsequent events." The ECJ's judgment was based on an analysis of the nature of the particular transaction in question—whether it is sufficient to be a "taxable transaction" ruled by the provisions in the Sixth EU VAT Directive. The result was that, "The right to deduct input VAT of a taxable person who carries out such transactions cannot be affected by the fact that in the chain of supply of which those transactions form part another prior or subsequent transaction is vitiated by VAT fraud, without that taxable person knowing or having any means of knowing."²⁰⁷ This result might seem contrary to the title of this section, but when the reason behind it is considered—the transaction involved fulfilled the objective criteria on which the definitions of those terms (economic activity, taxable transaction, taxable person etc., by which to determine a particular transaction falls into the scope of 2006 VAT Directive) are based, otherwise the existence of a VAT invoice, the decision was inconsistent with the settled case law of the ECJ—the substantial element outweighs the formal element. Therefore, the crucial element being considered here is always the substantial nature of the transaction in question and not the possession of a full VAT invoice.

4. Restrictions to the right of deduction in VAT

The deduction mechanism is one of the procedures in the process of the recovery of input VAT, the input VAT is not deductible or claimable by the subject (taxable person) unless the rules governing input tax recovery are met. Normally, these rules are, as aforesaid, (1) the input VAT relates to goods or services supplied to the taxable person; (2) the supplied goods or services are used (or are to be used) for the purpose of any

Customs & Excise, [2006] ECR I-00483.

²⁰⁷ See *Fulcrum Electronics Ltd and Bond House Systems Ltd*, supra n.205, at 55.

business carried on (or to be carried on) by the taxable person; (3) possession of a qualified VAT invoice. According to Article 2 of the First EU VAT Directive,²⁰⁸ the principle of the common system of VAT was to charge proportional tax on the supply of goods or services regardless of the number of transactions which take place in the production and distribution process, in other words, to maintain fiscal neutrality for the taxable persons. This requires a deduction of the amount of VAT borne directly by the various cost components on each transaction before the goods or services are supplied to the final consumer. However, due to the developments of the various VAT regulations of Member States before harmonization, and in addition, both the substantial difficulties and technical problems in some specific sectors of the VAT regime itself, VAT on certain expenses is non-deductible, even where the above requirements are met. The restriction to the right to deduct the input VAT in this section should be put into a broad interpretation, including both the situations in which (1) the right of deduction does not accrue from the beginning, and (2) the right existed but has terminated because of some reasons in its exercise. The first situation could be subdivided according to the provisions of the EU VAT Directive 2006: the restriction ruled in the Articles 176–177 in Chapter 3, “Restrictions on the right of deduction”, under Title X “Deductions”. According to the contents of these provisions and the relevant national legislation of the Member States, I will offer further discussion on the following two items: (i) non-deductible non-business expenses and non-deductible VAT for the business entertainment and (ii) non deductible VAT for exempt transactions (the input VAT is not deductible as there is no output tax due). For the second situation, I mainly refer to the time limitation for the exercise of the right to deduct the input VAT in the national legislation of Member States.

4.1 Non-deductibility of non-business expense

To determine whether an expenditure falls into the scope of input tax that should be excluded from deductible input tax, attention should be first paid to the distinction between business and non-business. According to Articles 167 and 168 of the VAT

²⁰⁸ First Council Directive 67/227/EEC of April 11, 1967 on the harmonization of legislation of Member States concerning turnover taxes.

Directive 2006 (which regulate the origin and scope of the right of deduction), VAT is deductible where the bought goods or services are used for the purpose of taxable transactions, without any requirement of business motive. In some Member States, the relevant provisions might be more specific, for example, in the United Kingdom, the legislation states that VAT is only deductible where the imposed goods or services are used or to be used for the purposes of any business carried on or to be carried on by the taxable person.²⁰⁹ Therefore, in the cases being referred to the ECJ for a preliminary ruling, the business purpose (or purpose of the business) is an inevitable subject to be considered. There is no legal definition of whether goods and services have been supplied for the purpose of business in the EU VAT Directives. Thus the test whether the input VAT is charged on a expense that has been incurred for the purpose of business is a subjective test. Normally, a nexus between the expenditure in question and the business is required, and the mere fact that the expense has been incurred and it is to the benefit of the business does not mean that it has been incurred for the purpose of the business²¹⁰. This test is extremely important when considering VAT deduction on the capital goods. If the relevant item is regarded as partly put into either private or non-business use, the corresponding amount of expenditure is in principle not deductible, while in practice, the deduction treatment might not always be absolutely apparent under the situation where the non-business expense is part of the overall expenditure on the whole asset and the expense on the part being used for private or non-business purpose could be hard to calculate.

In above-mentioned circumstance, where expense is incurred that is private or non-business for which no charge is made for the use of the items (part of goods or services received by a business), two methods are available to deal with VAT incurred

²⁰⁹ The primary provision in British law is the VAT Act 1994, § 24(1), which states: “Subject to the following provisions of this section, ‘input tax’, in relation to a taxable person, means the following tax, that is to say-

(a) VAT on the supply to him of any goods or services; (b) ... (c)...

being (in each case) goods or services used or to be used for the purpose of any business carried on or to be carried on by him.”

²¹⁰ For example, the legal costs of a taxable person who provides transportation services to preserve an employee’s driving license could not be seen as an expense for the purpose of business as it is regarded a close enough nexus between the goods and services supplied by the taxable person and the expense has not been established, notwithstanding the fact, that it is vital to the benefit of the business.

on the expense: the first option is the more practical one as it was generated from the ECJ's case law, called the Lennartz principle²¹¹. By this, all VAT could be claimed as long as the purpose of the purchase included business use at its initial time, and regarding the part of the items being put into private use, an output tax charge would be applied. In a more complete model, the Lennartz principle could be explained as deduction determined at the time of purchase. Thus, if an item is purchased for private use, then no input tax is deductible, even where there is subsequent business use. Where, however, an item is purchased for both private and business use, the taxable person could deduct all the input tax incurred and would then be required to account for output tax on the private use (and this would be valued at the cost of providing the item, including all costs incurred during the period that the item was available for private or non-taxable use) (see C-230/94). The charge of the output tax on private use is based on the principle of neutrality as VAT is a tax imposed on the final consumer, the part of the items being put into private use is seen as a supply to the final consumer. Therefore the non-deductibility of input VAT on the expense of the private or non-business use is achieved directly in the Lennartz principle method by charging output tax (which is not deductible as the non-business is viewed as final consumption). This solution is based on Article 26(1) of the VAT Directive 2006²¹² by which non-business use is treated as a supply of services and the output tax charged on it is consistent with the legislative intention of the article: to ensure equal treatment as between the taxable person and the final consumer with regard to non-business use. It therefore treats a taxable person making private use of goods forming part of the business in the same way as an individual who has acquired goods without entitlement to deduct.²¹³ This was first stated by the ECJ in *Kühne*,²¹⁴ in which it held

²¹¹ See, ECJ, July 11, 1991, Case C-97/90, *Hansgeorg Lennartz v Finanzamt München III*, [1991] ECR I-03795.

²¹² As Article 26(1) of the EU VAT (Art 6(2) of the Sixth EU VAT Directive) provides: Each of the following transactions shall be treated as a supply of services for consideration: (a) the use of goods forming part of the assets of a business for the private use of a taxable person or of his staff or, more generally, for purposes other than those of his business, where the VAT on such goods was wholly or partly deductible; (b) the supply of services carried out free of charge by a taxable person for his private use or for that of his staff or, more generally, for purposes other than those of his business.

²¹³ See ECJ, 8 May 2003, Case C-269/00, *Wolfgang Seeling v Finanzamt Starnberg*, [2003]

at paragraph 8 of the judgment that it is clear from the structure of the Sixth Directive that Article 6(2)(a) is designed to prevent the non-taxation of business goods used for private purposes and therefore requires the taxation of the private use of such goods only where the tax paid on their acquisition was deductible.

The alternative to the Lennartz principle is initial apportionment, by which VAT incurred on private or non-business use could not be deducted on the first deduction stage, in other words, VAT on goods used partly for a business purpose and partly for a non-business purpose should be apportioned and the deduction should be exercised proportionally. Unlike the proportional deduction for businesses that carry out both taxable transactions and exempt transactions, however, the proportionality could be particularly difficult to calculate as it relies upon knowing what the future use is and the intention is always difficult to prove. Obviously, in the application of this method, the taxable person is put in a rather difficult position, thus this is one of the arguments for using the Lennartz principle rather than initial apportionment. This method is, however, adopted in the situation where the initial intention to carry out the taxable transaction could not be realized, where the intention is aborted before it is actually carried out, in other words, there is no taxable use as Article 167 of VAT Directive 2006 gives the time of deduction as being the time VAT is chargeable. In the light of the elaboration of section 3.1 of this part on the immediate and direct link test in the situation where there is no immediate supply, it is not necessary to have actually made taxable supplies to enable VAT incurred to be deducted and VAT incurred is still reclaimable at the rate of the original intention²¹⁵. Therefore, an initial apportionment is required as the Lennartz method could not be applied here.

4.2 Non-deductibility of business entertainment

Article 176 of the VAT Directive 2006 (Article 17(6) of Sixth EU VAT Directive):
states:

ECR I-04101, at 34.

²¹⁴ ECJ, 27 June 1989, Case 50/88, *Heinz Kühne v Finanzamt München III*, [1989] ECR 01925.

²¹⁵ See ECJ, 15 Jan 1998, Case C-37/95, *Belgische Staat v Ghent Coal Terminal NV*, [1998] ECR I-00001.

The Council, acting unanimously on a proposal from the Commission, shall determine the expenditure in respect of which VAT shall not be deductible. VAT shall in no circumstances be deductible in respect of expenditure which is not strictly business expenditure, such as that on luxuries, amusements or entertainment.

Pending the entry into force of the provisions referred to in the first paragraph, Member States may retain all the exclusions provided for under their national laws at 1 January 1979 or, in the case of the Member States which acceded to the Community after that date, on the date of their accession.

It can be inferred from the first paragraph that expenditure that is not strictly business expenditure shall not be deductible. One of the terms exemplified here is entertainment. In fact, before the Directive was introduced, regulations excluding the input tax of business entertainment from the scope of deductible input tax already existed in many Member States. For example, in the United Kingdom, VAT incurred on business entertainment is not deductible as input tax, except where the entertainment is of employees or, in relation to a company, directors and persons in management of the company²¹⁶. In France, expenditure in respect of accommodation, food, hospitality and entertainment was gradually excluded from the right to deduct VAT between 1967 and 1979. The provisions excluding the right to deduct VAT charged on certain goods and services were set out in Articles 7 and 11 of Decree No.67-604 of 27 July 1967 (hence before 1 January 1979, the date on which the Sixth Directive entered into force)²¹⁷. The exclusion of the deduction of business entertainment expenses generally contains some exceptions for certain items supplied to employees or directors. Here I take the legislation about “business entertainment” in the United Kingdom as an example.

²¹⁶ See VAT (Input Tax) Order 1992, SI 1992/3222, art 5.

²¹⁷ Article 7 of the Decree No 67-604 provided: The tax on expenditure incurred in order to provide accommodation or lodging for the management and staff of undertakings shall not be deductible. However, that exclusion shall not apply to the tax on expenditure incurred in order to provide free accommodation at the place of work for employees responsible for the security or supervision of an industrial or commercial complex or a works site.

Article 11 of Decree No 67-604 provided: The tax on expenditure incurred in order to satisfy the personal needs of the management and staff of undertakings, and in particular the tax on the cost of providing hospitality, food and entertainment, shall not be deductible.

However, that exclusion shall not apply to expenditure in respect of:

Goods which constitute fixed assets and are specially allocated at the actual places of work for the collective satisfaction of the needs of the staff;

Work clothes or protective clothing which an undertaking provides for its staff

First, the term entertainment encompasses hospitality of any kind. The definition arises from the Court of Appeal decision *Shaklee International* [1981] STC 776, CA²¹⁸. Thus, entertainment can take many forms, such as the provision of food and drink; hotel accommodation and similar accommodation; shows, theater and concerts; entry to sporting events, clubs and nightclubs; and use of luxury goods such as yachts, aircraft or motor cars for the purpose of entertaining²¹⁹. For entertainment to become business entertainment, a set of conditions specified in item 2.1 of the VAT Notice 700/65 should be satisfied: (1) entertainment is provided; (2) it is provided to persons who are not employees of the business; (3) it is provided free. VAT incurred on business entertainment is in principle not deductible as input tax. There are always some exceptions from the normal rules, however, such as the exceptions displayed in the table of VAT Notice 700/65: a recognized sporting body provides through necessity free accommodation and meals to amateur sports persons and officials who attend an event; airlines provide catering and accommodation expenses for passengers who have been delayed. The scope of the deductible input tax for business entertainment is enlarged by the case law. Based both on the legislation and the case law, exception is made basically in the following circumstances: (1) the existence of a contractual reciprocal arrangement which made the freely given entertainment an obligation;²²⁰ (2) the receipt of a payment, normally not directly paid for the specific entertainment, which still makes it not entertainment;²²¹ (3) the entertainment serves as the basic content or an indispensable part of a business action.²²² The UK Customs and Excise department has accepted that there are a number of occasions where the

²¹⁸ In the case, the Court of Appeal stated: "... to give people free meals and to give them free accommodation is, to my mind to entertain them within the ordinary and natural meaning of the word. The proposition was strongly urged upon us, ... that 'entertainment' included hospitality...".

²¹⁹ See, VAT Notice 700/65: business entertainment, at 2.2.

²²⁰ For example, in the case *Custom & Excise v. Kilroy Television Co Ltd* [1997] STC 901, it was held that it was not business entertainment where persons participating in television programs were provided with a modest meal as the television company had placed itself under a contractual obligation to provide the meal.

²²¹ For example, in *City of Chicago Board of Trade (1992) VAT decision 9114*, it was held that the expenses of the cocktail party and champagne reception were deductible as delegates had paid to attend conferences.

²²² For example, in the *DPA (Market Research) Ltd (1997) VAT decision 14751*, the food provided in the product trials of drink which was organized by the market research company was not business entertainment as it was a necessary part of the trial.

input tax is deductible even though it appears that entertainment has been offered. Therefore, a set of examples of when input tax can be recovered in respect of “apparent business entertainment” are listed in its Internal Guidance V1-13, Chapter 2A, section 12.10.

Second, VAT incurred in the entertainment of employees is deductible although it is defined strictly both as to the object (employee) and the entertainment. Therefore, “employee” is a special term in VAT on business entertainment, as the entertainment of employees is legally excluded from the non-deductibility of VAT on “business entertainment”. The definition of employee is given by the UK Customs and Excise as “a person currently employed by the taxable person (including temporary or casual staff)”²²³. In VAT Notice 700/65, there are two exceptions to the general rule: (1) entertainment is provided to directors, partners or sole proprietors of the business, and (2) employees act as hosts to non-employees. Under the first situation, whether VAT could be deducted is determined by whether the entertainment is provided only to the aforesaid subjects (directors, partners or sole proprietors of the business): if the entertainment is provided only for directors or partners of a business then the VAT incurred is not input tax; but if directors and partners of the business attend staff parties together with other employees, then the tax will be accepted by the Customs and Excise as input tax and may be deducted. Second, where employees act as hosts to non-employees, it is the UK Customs and Excise policy that VAT incurred on the costs used for the sole purpose of entertaining a non-employee is non-deductible. Thus input tax on goods and services that are to be used for both business entertainment which is non-deductible and other non-entertainment business purposes or deductible business entertainment (such as the entertainment of employees) should be apportioned with regard to its deduction.

Another important and special item in relation to business entertainment is business gifts. In the United Kingdom, the business gift is deemed a kind of business promotion scheme, and according to VAT Notice 700/7, point 2.2, “a business gift is a

²²³ See Customs and Excise’s Internal Guidance V1-13, Chapter 2A, Para 12.4.

gift of goods that is made in the course of your business and for which you were entitled to reclaim the VAT you were charged on its purchase as input tax". VAT charged on the purchase of the products to be used as business gifts is therefore deductible. However, the output tax must be due on the supply of the gifts based on their cost value.²²⁴ In conclusion, the normal VAT taxation treatment of business gifts is, first, the input tax incurred on it is deductible; but, second, an output tax is due as well when it is given out²²⁵. A further exception is made when the total cost of all the gifts does not exceed £50²²⁶.

In China, no accurate definition is given either in the tax law or financial accounting systems on the scope of business entertainment²²⁷. In the practice of the tax authority, business entertainment normally contains the following items incurred because of the enterprise's business purpose (production or operation needs): (1) expenses of banquets or working meals; (2) expenses of gifts presented; (3) admission fees, transportation fees and other expenses incurred in visiting tourist attractions; (4) expenses of employees on business trips. Concerning the deduction of VAT on the expense of business entertainment, the current legal provisions are not very clear either. The relevant provisions are found in the mentioned PR-VAT and DRI-VAT, namely:

Article 10 of PR-VAT:

The input tax on the following items shall not be credited against the output tax:

²²⁴ See VAT Notice 700/7, at 2.1: "If you give away goods and are entitled to recover VAT on them as input tax and you receive no payment or other consideration for them, you must account for VAT on their cost value."

²²⁵ Regarding with the treatment of the output tax, it is deductible by the recipient under the condition that he uses the goods for business purposes with a normal invoice containing relative statement. Otherwise, it is not reclaimable. See VAT Notice 700/7, at 2.4.

²²⁶ See VAT Notice 700/7, at 2.3.

²²⁷ On 14 May 1998, the Ministry of Finance issued the notice "Regulations of the Allocation of Business Entertainment Expense of Administrative Institutions", FB [1998] No. 159. The scope of business entertainment expense was ruled in point 2: "The term business entertainment expenses, refers to the reception expenditure of the administrative institutions which is reasonably necessary to perform their official duties or to conduct their business activities." This notice was applied only to the administrative institutions and obviously not adapt to business enterprises. Reception costs expenditure. Include: transport fares occurred in the reception areas, dining and lodging expenses.

(1) taxable items used for non-VAT, items exempt from VAT, and goods or taxable services purchased for collective welfare or individual consumption;

(2)—(5) ...

The newly added²²⁸ article 22 of the DRI-VAT:

The individual consumption mentioned in Article 10 (1) of the Regulations includes the social intercourse expenses of the taxpayers.

Article 4 of DRI-VAT:

The following activities of a unit or an individual industrial and commercial household shall be deemed as sale of goods:

(1)—(3) ...

(4) Use of self-produced goods or goods processed on commission from non-VAT taxable items;

(5) Use of self-produced goods or goods processed on commission for collective welfare or personal consumption;

(8) Donation of self-produced or purchased goods or goods processed on commission to other units or individuals without compensation.

The interaction of the above provisions results in great disputes in practice with the treatment of VAT imposed on the goods or services used in business entertainment, especially for the business gifts. There are in principle three viewpoints. The first holds that, inferring from the meaning of the previous two joint provisions (Article 10 of PR-VAT and Article 22 of the DRI-VAT), business entertainment (social intercourse expenses) is viewed as personal consumption by Article 22 of the DRI-VAT. At the same time the latter is excluded from the scope of deductible input tax by Article 10 of the PR-VAT, naturally the former is excluded, and the business gift which is included in the business entertainment is not deductible either. The second viewpoint is, based on Article 4(8) of the DRI-VAT, that the action of an enterprise to give self-produced or purchased goods or goods processed on commission to other units or individuals without compensation is deemed as sale of goods, output tax is charged on it, thus the input VAT is deductible. The third view is based on Article 4(5) of the

²²⁸ This article was newly added in to the DRI-VAT in 2008, aiming at consistency with the international practices.

DRI-VAT, in which only the use of self-produced goods or goods processed on commission for collective welfare or personal consumption is viewed as sale of goods, but not the use of goods purchased from outside. Thus is the input VAT on the outsourcing of goods is non-deductible.

In my view, based on the current regulations mentioned above, in China, first, input tax on goods or taxable services purchased for business entertainment in general terms is not deductible (see Article 10 of PR-VAT), while the same use of the self-produced goods or goods processed on commission should be viewed as sale of goods and an output tax is due (according to Article 4(5) of the DRI-VAT). Second, with regard to the goods used as gifts (not only business gifts, but also the gifts given personally and without any business purpose), no discrimination is made based on the source of the goods, the donation of both self-produced goods or goods processed on commission and purchased goods ought to be viewed as sale of goods (according to Article 4(8) of the DRI-VAT). Thus, the different treatment of input VAT on purchased goods used as business gifts and for business entertainment is like the difference between the general and the special. A simple table illustrates this point (Table 6).

Table 6: VAT treatment of business entertainment and business gifts

Source of the used goods	Types of usage	VAT tax treatment
Self-produced or processed on commission	Business entertainment	Deductible input VAT combined with output VAT due (viewed as sale of goods)
	Business gifts	Deductible input VAT combined with output VAT due (viewed as sale of goods)
Purchased from outside	Business entertainment	Non-deductible input VAT, not clear on output VAT due
	Business gifts	Deductible input VAT combined with output VAT due (viewed as sale of goods)

The distinction in the treatment of the outsourced goods due to the types of usage is reasonable as the goods used in normal business entertainment are usually viewed as being finally consumed and the chain of deduction in VAT is completed, while those used as business gifts do not mean the end of the deduction chain. This is why in the United Kingdom, the recipients of gifts on which output VAT is due could reclaim the charged VAT if the received gifts are put into use for business purposes²²⁹. Therefore, in my opinion, VAT treatment of the goods used for business entertainment or business gifts should not be distinguished only on the types of use, but on the judgment of the position of the used goods in the deduction chain of VAT. However, the current Chinese legislation does not completely correspond with this principle and the confusing provisions lead to the above-mentioned arguments.

²²⁹ See VAT Notice 700/7, point 2.4 states: “if you make a gift of goods on which VAT is due, to someone who uses the goods for business purposes, that person can, if they are VAT registered, recover the VAT as input tax subject to the normal rules. You cannot issue a VAT invoice but, in order to provide the recipient with acceptable evidence to support a claim for recovery of input tax, , you may use your normal invoicing documentation and include the following statement...”.

4.3 Restriction of the right of deduction under the exempt condition

The goods or services purchased by a taxable person on which VAT is incurred can be put into use for one or more of the following activities: (1) personal or non-business activities; (2) making taxable supplies; (3) making exempt supplies; (4) making out-of-country or specified supplies. In most accounting systems, the identity and exclusion of the input VAT that should be outside the scope of deductible VAT is relatively easy for the above items (1) (see part 1 of this section) and (3). With regard to the item (2), the input VAT incurred is usually deductible, but it may not be deductible under certain circumstances, for example, VAT incurred on cars put to private use, or business entertainment (as expressed in the previous sub-section).

Concerning the treatment of exempt supplies, this is the product of both compromises made for the promotion of VAT²³⁰ and technical difficulties²³¹. Despite the controversial existence of exemptions in VAT systems, exemptions cannot not be eliminated for quite a long time. Thus regardless of the arguments about its presence, the discussion of this part focuses on the right of deduction related to exempt supplies.

In most of the current VAT systems, the exemption can be divided into two categories: exemption for special suppliers (hereinafter supplier-exemption) and exemption aimed at special supplies (hereinafter supply-exemption). Supplier-exemption mainly refers to the small business kept immune from normal VAT by the registration threshold. With regard to the supply-exemption, the most typical types of VAT exemption are the supply of certain merit goods and those due to technical difficulties, such as some transactions on immovable property and in financial and insurance

²³⁰ To gain the acceptance needed for the change from a turnover tax to VAT, the initial VAT contained a wide range of implicit subsidies by way of reduced rates for some types of supplies and “exemption” for selected other types of supplies, which often replicated those that had been in place under the previous turnover taxes. See Rita de la Feria and Richard Krever, “Ending VAT Exemptions: Towards a Post-Modern VAT”, in *VAT Exemptions: Consequences and Design Alternatives*, Wolters Kluwer Law & Business, 2013, pp. 8-9.

²³¹ The exemptions are adopted for technical reasons implied that these exempted activities would ideally have been subject to VAT, but being decided as exempt out of the pragmatic considerations. For example the exemption for financial and insurance services.

services. No matter to which category an exemption belongs, the term “exempt” signifies no output tax is borne by the supplier and thus the supplier need not collect or remit any tax in respect of the relative supply. Understood from the perspective of the right of deduction this means that no input tax credit is allowed in respect of tax assessed on acquisitions related to the making of the supply²³². The right of deduction is not in consideration in the situation of VAT exemption, this is backed by the original nature of VAT—a tax on final consumption. As no output tax is incurred, there is no offsetting of items for input tax as a result, and no right of deduction comes into being. The restriction to the right of deduction in respect of exempt supplies thus seems to be “reasonable”, while from the perspective of the scope and nature of VAT itself—an indirect tax on consumption expenditure²³³ designed to burden the final consumer even though collected by economic operators as taxable persons²³⁴—its existence in the VAT system is quite unreasonable. This is why Amand thought VAT exemptions were probably the most complex aspect of the European VAT system²³⁵. Disputes arise as the exemptions in the VAT system not only cause distortions of competition and provide space for most VAT planning, but also put extra burdens on both the taxable persons and tax authority, the latter problem is particularly obvious in the partial exemption situation where the taxable person carries both taxable and exempt transactions.

The term “partial exemption” is used to refer to the process by which a partly exempt business²³⁶ applies to determine the quantum of input tax that can be deducted. Although no sign of the term “partial exemption” appears in the EU VAT

²³² The terms “exempt without credit” (used in Portugal for example) and “input taxed supplies” (used in Australia for example) seems more accurate than the term “exempt supplies” used in most VAT systems.

²³³ This could be drawn from the content of article 1(2) of the VAT Directive 2006: “The principle of the common system of VAT entails the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services, however many transactions take place in the production and distribution process before the stage at which the tax is charged.”

²³⁴ See Joachim Englisch, *The EU Perspective on VAT Exemptions*, VAT Exemptions: Consequences and Design Alternatives, Wolters Kluwer Law & Business, 2013, p .39.

²³⁵ See C. Amand, “Are VAT Exemptions Compatible with Primary EU Law?” *International VAT Monitor*, 2010, 21(6).

²³⁶ A partly exempt business refers to a VAT registered business that incurs any input tax that will be used to make exempt supplies.

Directives,²³⁷ there are relative provisions dealing with partial exemption. The VAT Directive 2006 provides the framework for partial exemption in Articles 167–169, and 173–175. Article 167 provides the time at which input tax is deductible: “A right of deduction shall arise at the time the deductible tax becomes chargeable.” Thus, in a given period, any VAT charged is immediately deductible at the same time. The subsequent Articles 168 and 169 provide for the specific supplies which entitle the taxable person to deduct input VAT. Then Articles 173, 174 and 175 provide the detailed apportionment method for the input VAT which is not directly attributable. In the well-established case law, the provisions of Articles 167–174 are consistently interpreted as, to be deductible, an immediate and direct link test shall be carried out, which means VAT must be incurred on cost components of the supply or supplies in respect of which a deduction is permitted.

Normally the partial exemption process is composed of the attribution process and the apportionment process. The attribution process aims to the attribution of the whole input tax incurred. It has two steps; the first is the exclusion of the non-deductible input tax, such as the input tax incurred in the aforementioned cases. Second is the direct attribution by which the input tax can be attributed solely to a specific category of supplies, either taxable supplies or exempt suppliers. After these two steps are taken, the remaining input tax (the whole input tax incurred less the non-deductible input tax and the directly attributed input tax) is usually referred to as residual or “pot” input tax.²³⁸ Once the input tax has been attributed to specific categories of supplies, the apportionment process may apply in order to determine the quantum of input tax in each category. The determination of the quantum of the categories in the direct attribution is quite straightforward: 100% is recoverable for input tax directly attributable to taxable supplies, and nil for input tax directly attributable to exempt supplies. The most complicated and difficult juncture in the apportionment process is the determination of the quantum of the deductible input tax for the residual input tax.

²³⁷ ‘Proportional deduction’ is applied in the VAT Directive 2006, while the proportional deduction is not equal to the ‘partial exemption’, actually, the latter is included in the former, as the proportional deduction is the calculation of the deductible input VAT based on all the supplies made by the business.

²³⁸ Refers to the input tax that cannot be directly attributed to taxable or exempt supplies.

The method for the determination of the quantum of the deductible input tax for the residual input tax is provided in Article 174(1) of the VAT Directive 2006:

The deductible proportion shall be made up of a fraction comprising the following amounts:

(a) as numerator, the total amount, exclusive of VAT, of turnover per year attributable to transactions in respect of which VAT is deductible pursuant to Articles 168 and 169;

(b) as denominator, the total amount, exclusive of VAT, of turnover per year attributable to transactions included in the numerator and to transactions in respect of which VAT is not deductible.

Member States may include in the denominator the amount of subsidies, other than those directly linked to the price of supplies of goods or services referred to in Article 73.

Articles 174 and 175 further provide for the derogation and adjustment of the basic calculation. In addition, in Article 175(2), the Directive authorizes the Member States to retain their own rules that were in force prior to January 1, 1979 or the date of their accession to the EU.²³⁹

Thus the method provided by the VAT Directive 2006 is called the standard method, as well as being a value-based method, as it works in the way: make references to the comparative values of taxable supplies and all supplies. This calculation can be shown by the following formula:

$$\frac{\text{Value (exclusive of VAT) of taxable supplies}}{\text{Value (exclusive of VAT) of taxable and exempt supplies}} \times 100$$

Thus, the deductible quantum of residual input tax is made up of two elements: the input tax directly attributable to taxable supplies and the deductible proportion of residual input tax. According to the provisions of the VAT Directive 2006, the standard method should be applied in each “prescribed accounting period” by the partly exempt business, thus an annual adjustment is made to counter the effects

²³⁹ However, Member States may retain the rules in force at January 1, 1979 or, in the case of the Member States which acceded to the Community after that date, on the date of their accession.

of fluctuations of provisional attribution²⁴⁰. Normally the standard method is applied by the Member States in the situation where residual input tax is incurred wholly in respect of transactions within their own territory. With regard to the input tax incurred in respect of foreign or specified supplies, a different method might apply. To take the United Kingdom²⁴¹ as an example, the standard method is regulated in reg. 101(2)(d) of the VAT Regulations 1995²⁴². In reg. 103 of the same Regulations a use-based method is provided to determine the deductible input tax quantum where input tax is incurred in respect of foreign or specified supplies²⁴³. Whatever method is applied, the final purpose is the same: to ensure all the deductible VAT borne by the taxable person is deducted, and no more; in other words, to ensure the realization of the principle of neutrality in the VAT system. Thus, the criterion of “fair and reasonable” was set up in Section 26(3) of the UK VAT Act 1994²⁴⁴ to secure the principle of neutrality. And precisely out of this criterion, the use-based method was applied as an alternative method to the standard method.²⁴⁵ Therefore, in the United Kingdom, the standard method provided in Article 174 of the VAT Directive 2006 is only partly implemented since first it applies only insofar as domestic supplies are concerned; and second, an alternative method may be applied if the standard method does not provide a

²⁴⁰ This is because the relative proportions of exempt supplies might vary significantly from one prescribed accounting period to the next (for example a business has a seasonal fluctuations).

²⁴¹ The UK primary legislation implementing the provisions of the Sixth Directive arts 17 and 19 (now the VAT Directive 2006, arts 167-169 and art 174) are found in VAT Act 1994, sections 24-26. The detailed provisions are primarily in VAT Regulations 1995, regs 99-111.

²⁴² In which, it provides: “In respect of each prescribed accounting period— ... (d) there shall be attributed to taxable supplies such proportion of the input tax on such of those goods or services as are used or to be used by him in making both taxable and exempt supplies as bears the same ratio to the total of such input tax as the value of taxable supplies made by him bears to the value of all supplies made by him in the period.”

²⁴³ In which, it provides: “(1) Input tax incurred by a taxable person in any prescribed accounting period on goods imported or acquired by, or goods or services supplied to, him which are used or to be used by him in whole or in part in making—

(a) supplies outside the United Kingdom which would be taxable supplies if made in the United Kingdom, or

(b) supplies specified in an Order under section 26(2)(c) of the Act, shall be attributed to taxable supplies to the extent that the goods or services are so used or to be used expressed as a proportion of the whole use or intended use.”

²⁴⁴ In which, it provides: “The Commissioners shall make regulations for securing a fair and reasonable attribution of input tax to supplies within subsection (2) above, and any such regulations may provide for— ...”.

²⁴⁵ This is because, the operation of the standard method might cause unreasonable compliance costs or other unfair results for some specific supplies.

fair and reasonable attribution of input tax to taxable supplies.

In the light of the partial exemption process described above, the whole work process to determine the final deductible input tax is quite complex, especially the standard method applied to calculate the deductible quantum of the residual input tax. The tedious procedures may lead to additional compliance costs for enterprises as well as affecting the best use of public resources, which is also one of the reasons to object to the existence of the exemption mechanism in a VAT system. To simplify the procedure, the *de minimis* limit²⁴⁶ is applied on conditions in most Member States. In the United Kingdom, the exempt input tax is regarded as attributable to taxable supplies if the amount is less than £625 per month (that is, £7500 per annum) on average and does not exceed half of the total input tax incurred in the prescribed accounting period. The exempt input tax consists of both the input tax directly attributable to exempt supplies and to the non-deductible amount of residual input tax, and excludes non-deductible input tax (such as VAT on the costs of business entertainment) which is irrecoverable.²⁴⁷ Notwithstanding the simplification, the text for the business to confirm its *de minimis* status also requires certain works and the time point of the application of the rule seems a little late, in my view. To simplify the partial exemption process further, the *de minimis* limit rule could be take forward to the first attribution process—to determine whether input tax has been used exclusively for the making of taxable or exempt supplies. For example, in the situation where the whole input tax incurred both in making €1,000,000 of exempt supplies and only €100 of taxable supplies, under the current attribution process, the distinction is made, which is arguably not to attribute the input tax directly and totally to exempt supplies.

In China, no substantial partial exemption exists in the current VAT system. The only

²⁴⁶ The rule is applied where the trader's exempt input tax is insignificant, the result of its application is, the insignificant exempt input tax being treated as if it were taxable input tax and recover it in full if its total value is less than a prescribed amount.

²⁴⁷ See VAT Regulations 1995, reg 106 and VAT Notice 706: partial exemption, at 11.2.

relevant provision is Article 16 of the PR-VAT, which provides:

For taxpayers engaged in tax exemption and reduction items concurrently, the sales amounts therefor shall be calculated separately. If the sales amounts have not been separately counted, no tax exemption or reduction is allowed.

The relative detailed rule of its implementation is Article 36 of the DRI-VAT.²⁴⁸

Where the sold goods or taxable services provided by taxpayers are applicable to the provisions on exemption of taxes, the taxpayers may give up the said exemption and pay VAT according to the Regulations. The taxpayers shall not apply for exemption of tax within 36 months after its/his waiver of such exemption.

Based on the provisions above, the treatment of the deduction for a partly exempt business is quite straightforward—fully deductible for the taxable supplies and totally non-deductible for the exempt supplies—on the basis of the separately calculated sales amounts. The partial exemption process is terminated at the attribution process, with no consideration of the residual input tax incurred on the transactions that could not be completely classified into the category of taxable transactions or exempt transactions.

The considerations behind the described system design for the partly business mainly about the economic efficiency out of the restricted resource of the tax administration and the taxpayer's compliance costs. In my view, the considerations are understandable based on the current national conditions of China. However from the perspective of the long term and the negative impacts resulting from the system's design, it requires urgent improvement. In the existing system, a simple classification of the category of the sales amount provides the soil and space for tax fraud or at least loopholes. Such an improvement is not so far that it will be blocked by current conditions, because one of the important natures of legislation is prospective. On the other hand, on the balance of the positive and negative impacts, the latter is much "heavier" than the former. In addition, the economic efficiency could be enhanced by solving the inefficiency

²⁴⁸ This article was newly added in 2008, which was inconsistent with the prevailing practices.

of the tax administration. In fact, the actual obstruction that hinders the improvement of the partial exemption process in China is the professional qualities and vocational skills of the tax administration's employees and the imperfect accounting system of the traders. All the above difficulties should not be an excuse to the existing imperfect design of the partial exemption, but motivations for its improvement.

5. The treatment of the excess of the deductible amount

As mentioned Part I, section 1.3, the right of deduction and the right of refund²⁴⁹ are two distinct but closely connected rights within a VAT system. In fact, they are the two processes in the procedure of the recovery of the VAT deductible. The right of deduction is exercised prior to the right of refund, and the right of refund is not absolutely generated as it is an optional choice for the treatment of the excessive deductible input tax.

On the level of the EU, harmonization of the refund of VAT²⁵⁰ is mainly focused on refund of VAT to taxable persons not established in the Member States providing refund, as provided in Article 170 of the VAT Directive 2006. The detailed rules were laid down in the Council Directive 2008/9/EC of February 12, 2008. While it concerns the present discussed domestic refund of the excessive amount of deductible input VAT, the choice of the specific arrangements could be freely made by the Member States as authorized by the EU in Article 183 of the VAT Directive 2006:

Where, for a given tax period, the amount of deductions exceeds the amount of VAT due, the Member States may, in accordance with conditions which they shall determine, either make a refund or carry the excess forward to the following period.

However, Member States may refuse to refund or carry forward if the amount of the excess is insignificant.

²⁴⁹ The right of refund here refers to the treatment of the over-amount of deductible input tax during a tax period of a domestic enterprise. With no consideration of the refund be made by the Member States to the taxable person not established within their territory, under Article 170 of the VAT Directive 2006.

²⁵⁰ The refund of VAT here refers to a much broader scope, which contains both the refund of VAT made by the Member States to the non-resident taxable persons and the refund of the excessive amount of deductible input VAT within their territory.

According to the above provision, the arrangements for the excess deductible input tax could be different in the VAT systems of Member States. In general, most of the Member States choose normally to carry forward or to refund subject to certain conditions. Here I take the United Kingdom and Italy as examples, and make a brief introduction of the related arrangement in China.

The VAT refund arrangement in the United Kingdom is mainly regulated by the VAT Act 1994, § 25, “Payment by reference to accounting periods and credit for input tax against output tax”, in which, sub-sections (3) and (4) state:

(3) If either no output tax is due at the end of the period, or the amount of the credit exceeds that of the output tax, then, subject to subsections (4) and (5) below, the amount of the credit or, as the case may be, the amount of the excess shall be paid to the taxable person by the Commissioners; and an amount which is due under this subsection is referred to in this Act as a “VAT credit”.

(4) The whole or any part of the credit may be held over to be credited in and for a subsequent period; and the regulations may allow for it to be so held over either on the taxable person’s own application or in accordance with general or special directions given by the Commissioners from time to time.

From the provisions above, a payment of the amount of the excess (“VAT credit”) to the taxable person is the basic and principal solution in the United Kingdom with regard to the treatment of excess deductible input tax. At the same time, an alternative choice to carry forward the ‘credit’ to the subsequent tax period is adopted under two conditions: (1) on the taxable person’s own application; (2) in accordance with general or special directions given by the Commissioners.

When it comes to the situation in Italy, the VAT refund discussed in this section was governed by Article 30 of the Italian VAT Code (DPR 633/72)²⁵¹, which is applied to resident VAT taxpayers in Italy. In point (2)²⁵², if the annual return

²⁵¹ In force since February 20, 2010—with effect from January 1, 2010, amended by: Legislative Decree of 11/02/2010 n. 18 Article 1.

²⁵² The original statements of Article 30 (2): “Se dalla dichiarazione annuale risulta che l'ammontare detraibile di cui al n. 3) dell'articolo 28, aumentato delle somme versate mensilmente, è superiore a quello dell'imposta relativa alle operazioni imponibili di cui al n. 1) dello stesso articolo, il contribuente ha diritto di computare l'importo dell'eccedenza in detrazione nell'anno successivo, ovvero di chiedere il rimborso nelle ipotesi di cui ai commi successivi e comunque in caso di cessazione di attività.”

shows that the amount deductible under n. 3) of Article 28, the sum of the amounts paid monthly, is higher than the tax on the taxable transactions referred to in n. 1) of the same article, the taxpayer is entitled to carry forward the amount of the excess deductible to the subsequent year, or to request a refund in the cases referred to in the following paragraphs and in case of cessation of activity. The subsequent paragraphs (3) and (4) provide the conditions to be met in order to be entitled to the refund, basically two aspects: (1) the excess amount is over 5 million lire (around €2500') and at the same time meets certain conditions listed in the same paragraph; (2) the excess amount deductible not only resulted in the annual declaration being prepared, but also in those of the two previous years. In the latter case, a refund is allowed to the sum of the annual credits of this three-year period, relative to the part that has not already requested a refund, even if an amount equal to or less than €2,582.28.

Therefore, the arrangement in Italy is more favorable to the Treasury compared with the United Kingdom, as to carry forward the excess amount deductible to the subsequent year is the principal arrangement. However, when we turn to China, the inclination to the state's interest might be more obvious. In China, the relevant arrangement is ruled in Article 4 of PR-VAT, which mainly deals with the specific method adopted to calculate VAT due:

(1) Except as stipulated in Article 11 of these Regulations, for taxpayers engaged in the sale of goods or provision of taxable services (hereinafter referred to as "selling goods or taxable services"), the tax payable shall be the balance of output tax for the period after deducting the input tax for the period. The formula for computing the tax payable is as follows: Tax payable = Output tax payable for the period - Input tax for the period.

(2) If the output tax for the period is less than and insufficient to offset against the input tax for the period, the excess input tax can be carried forward for offset in the following period.

Viewing the provision from both its structure and content, I should point out that the arrangement is not satisfactory. First, the treatment of the excess of the deductible input tax does not receive enough attention, as it is mentioned in the

sub-paragraph which is dealing with the computation of the tax due. No more detailed rules are provided for its implementation in the DRI-VAT. Second, the treatment is quite questionable from the perspective of fairness. In its content, the only treatment for the excess of the deductible input VAT is to carry it forward to the following period, while refund is not allowed. This arrangement has not taken consideration of the interest of taxable persons, especially seasonal enterprises, where the excess of deductible input VAT might accumulate to a significant amount which can result in harming the cash flow of businesses under the current arrangement. Thus, three alternative methods have been proposed in the literature in China, which are more or less like the arrangements in the United Kingdom and Italy: (1) enable taxable persons to make the choice whether to carry forward or apply for a refund; (2) set a mandatory carried-forward period (annual or quarterly), so that the refund is not allowed until to the end of the set period if there is still the balance, no matter how much it is; (3) set a threshold (a minimum amount) for the application of refund; only when the amount exceeds the set threshold could it be refunded, otherwise it will be carried forward to the subsequent period.

The consideration behind the arrangement, from my point of view, is the balance between the interests of states and of taxable persons. In the interest of states, the main consideration is the assurance of the revenue which is likely to be threaten by the obligation to pay refunds, as it is likely to be taken advantage of by taxpayers (inclined to perform tax fraud). For the interest of the taxable person, lack of refund may result in the loss of cash flow, and potentially fatal damage to enterprises. The choice made by China was based on the context of that time (in 1994): based on lack of executive power and the enforcement cost, more attention was paid to the interest of the state. With more recent developments, the related VAT arrangement should be updated as well. At least, an arrangement totally without consideration of the interests of taxable persons is not reasonable or acceptable. The appropriate treatment should be made on the basis of China's

current situation. I am in favor of the combination of the above-mentioned methods (2) and (3): allowance of refund if the excess amount is over a set threshold, otherwise, the excess should be carried forward for a mandatory period, and the period should be continuous and uninterrupted.

Chapter 3 Value-Added Tax in China

1. Historical overview of VAT in China

VAT, with its specific and unique feature as a neutral form of taxation, has enjoyed a rapid diffusion around the world since its first adoption in Europe. China too has chosen to adopt VAT in an attempt to promote its economic development.

1.1 The brief but changeable history of VAT in China

Compared with VAT in Europe, VAT in China has a much shorter history, not just as a matter of time but also concerning the whole system design as well. However, at the very beginning of its establishment in China²⁵³, VAT demonstrated many similarities with VAT in Europe, such as the method adopted to calculate VAT liability, the invoice credit method, and the “new” VAT system which was initially established in 1994²⁵⁴ adopted many attributes from European VAT as well. In addition, in its reform in history as well as the ongoing reform in China, the European VAT has or will play an important role either to give experience or to provide reference, evidence of which is set out below.

The development route of VAT in China and its chief features in each period are shown in Table 7.:

²⁵³ The concept of VAT was introduced as a means of fair taxation in 1984. Prior to its formal adoption, China started the feasibility study of adopting VAT from 1979.

²⁵⁴ Prior to 1994, VAT in China treated differently between the domestic-sourced business and the foreign-invested business. And the scope of VAT is rather restricted.

Table 7. Development of VAT in China

Period	Economic Background	Development Process	Main Features
Prior to 1979 ²⁵⁵	<i>a.</i> Planned economy; <i>b.</i> Profits of enterprises ²⁵⁶ was the main fiscal revenue, not the tax.	No VAT	No
1979–1994	<p>a. Planned economy turned to planned commercial economy (post 1978);</p> <p>b. Reform of economic system and opening-up policy</p> <p>c. Tax revenue generally substituted SOE profits as the main fiscal revenue.</p>	<p>a. In 1979, the feasibility study of the introduction of VAT was carried out;</p> <p>b. From 1980, VAT was imposed on certain sectors²⁵⁷ in limited cities as pilots;</p> <p>c. In 1983, VAT was charged throughout mainland while still limited to certain sectors;</p> <p>d. In 1984, the State Council issued the draft Value Added Tax in People’s Republic of China (draft).</p>	<p>a. Complicated tax rates as part of design²⁵⁸;</p> <p>b. Very limited tax base (VAT charged on certain products and not imposed at all stages);</p> <p>c. Only introduced VAT method of taxation, not the true sense of the value-added tax;</p> <p>d. Foreign-invested businesses (FIBs) were subject to different system of indirect taxes²⁵⁹ (more favorable than domestic enterprises, in accordance with opening-up policy).</p>

²⁵⁵ The main issue to be addressed of this period was to establish State authority, which has posed and is still posing great effects to the Chinese whole taxation system, and VAT has not ‘escaped out of’ its strong influence.

²⁵⁶ State-owned enterprises (hereinafter SOE), the State owned enterprises have no right of making of their own management decision, as in the planned economy, the quantity of goods to be produced was allocated. Therefore, the finance of the enterprises was an extension of the State’s finance, and since there is no need to adjust economy and redistribute welfare through taxation, tax played a dispensable role in that period.

²⁵⁷ The first two chosen sections were equipment and machinery and farm implements, as the repeat taxation in these two sections were most serious. In 1981, the scope was extended to the following three products: bicycles, electric fans and sewing machines.

²⁵⁸ In this period, the nation-invested enterprises and the foreign-invested enterprises were subjected to different tax rates arrangements. For the former ones, 13 rates were applied, ranging from 8% to 45%; and for the later ones (which were subjected to industrial and commercial tax), up to 40 rates were applied, ranging from 1.5% to 69%.

²⁵⁹ The foreign-invested enterprises were subjected to industrial and commercial tax at that time.

Period	Economic Background	Development Process	Main Features
1994-2004	<p>a. Market economy;</p> <p>b. Encouragement of development of private economy;</p> <p>c. To deepen the opening up and integrate into international community;</p> <p>d. Tax became the major fiscal revenue.</p>	<p>a. Late 1993, a more thorough comprehensive reform was carried out in China's industrial and commercial tax system;</p> <p>b. January 1, 1994, "The Interim Regulations of the People's Republic of China on Value-Added Tax" came into force</p>	<p>a. A 'new' VAT system* was set up, a productive type VAT (as the input tax of fixed assets was not allowed to deduct);</p> <p>b. Simplified the degree of tax rates: basic rate (17%), low rate (13%) and zero rate;</p> <p>c. Expanded the scope of VAT (still very limited)²⁶⁰;</p> <p>d. Adopted credit invoice method to calculate tax liability;</p> <p>e. Made a distinction between taxpayers: general and small-scale²⁶¹;</p> <p>f. Both domestic enterprises and FIBs subject to the 'new' VAT system;</p> <p>g. Coexistence of two types of turnover tax—VAT and business tax (BT)</p>

* Due to the unfavorable prevailing economic conditions (and other various reasons), VAT established then had defects both from of depth and breadth. Regarding depth, it was mainly related to the incomplete deduction, as fixed assets were not included in the deductible range. In other words, it was production-type VAT, which was not conducive to encouraging business investment in equipment and technical progress. Regarding breadth, it was the not fully comprehensive coverage of VAT; the scope of VAT was limited to the sales of goods, provision of processing, repairs and replacement services. Other sectors (the remaining services, immovables and intangibles) were subject to business tax.

²⁶⁰ The scope of VAT is stipulated in Article 1 of "The Interim Regulations of the People's Republic of China on Value-Added Tax": the sales of goods, provision of processing, repairs and replacement services, and the importation of goods within the territory of the People's Republic of China.

²⁶¹ For the small-scale taxpayer, tax rates were 6% and 4%, which respectively applied to different sectors. And the tax base was turnover of the business, in order to simplify the calculation of tax liability.

Period	Economic Background	Development Process	Main Features
2004-now	<p><i>a.</i> Emphasis on neutrality and equality of VAT²⁶²;</p> <p><i>b.</i> Further internationalization</p>	<p><i>a.</i> In 2004, start of pilot program²⁶³ of transferring the production-type VAT to consumption-type VAT;</p> <p><i>b.</i> In 2008, the State Council revised Provisional Regulations on VAT to expand the transformation reform nationwide²⁶⁴;</p> <p><i>c.</i> January 1, 2012, another important VAT reform began with a pilot program in Shanghai, aiming at replacing business tax (BT) with value added tax (VAT).</p>	<p><i>a.</i> Rational simplification and geared to international standards;</p> <p><i>b.</i> Transfer production-type VAT into a consumption-type VAT, but not completely;</p> <p><i>c.</i> New challenges and problems come into being²⁶⁵.</p>

²⁶² Be influenced by the prior periods, especially during the transition from the planned economic to the market economic, emphasis and focus were totally put on the efficiency, which was the central topic of all the aspects of nation-building, and the design of VAT system was also guided by the principle of efficiency rather the principle of neutrality.

²⁶³ The pilot program was started in the Northeast region, where was the Old Industrial Base of China.

²⁶⁴ The reform included only the machinery and equipment to the scope of input tax deduction, not all the fixed assets. Nevertheless, it has taken a substantial step forward to transfer the production-type VAT to consumption-type VAT.

²⁶⁵ Especially with the expansion reform, which was started in 2012, tax administration and the tax system design faced difficulties in the sections which was previously charged by business tax, thus, a new transitional system is set up, which might lead to the emergence of new problems or hidden trouble to the future VAT system.

1.2 The historical development trends of VAT in China and its future directions

From the history of the development of VAT in China, we can infer that it is evolving in accordance with the requirements of different eras in China's recent history, and is especially closely related to economic development. Fortunately, from my point of view, it is changing in the right direction. First, it is turning into a consumption-type VAT; having long been a production-type VAT mainly based on the requirements of controlling the scale of investment, guiding investment orientation and adjusting the investment structure. In other words, at its initial introduction, VAT played much more the role as a tool of the government's macro-control of the national economy²⁶⁶. With economic development and the reform of the tax system per se, VAT has a new mission, in particular, its assurance of the principle of neutrality is taken seriously, in place of the blind pursuit of efficiency. All the factors push the previous production-type VAT into a consumption-type VAT. However, there is a long way to go for a complete change. For the current moment, VAT is heading in the right direction, but is still far from the desired end. Second, generally VAT is turning into the sole indirect tax imposed on the circulation of commodities. The remarkable sign is in two recent reforms, especially the latter one, which is still ongoing, aiming at completely replacing business tax. This is catering to the requirements of both the domestic economic development and the international competition. Since the "new" VAT system was set up in 1994, China has run a dual turnover tax system for more than 20 years, that is, the sale of goods and supply of services are respectively subjected to VAT and business tax. This arrangement played an important role in the establishment of the socialist market economy. However, the current situation of economic development needs to optimize the industrial structure further, and the coexistence of the two taxes posed an increase obstruction to the development of service industries which are characterized by specialization and industrial integration²⁶⁷. Third, the inherent features of VAT itself give cause for concern in the

²⁶⁶ There were also other factors to consider, such as the level of tax collection of that time.

²⁶⁷ This is because, in the current tax structure, both the business tax charged on the purchased services, which is borne by VAT taxpayer, and the value added tax imposed on the purchased goods, which is

Chinese context. As mentioned in chapter 1, VAT has its own legal character, which should be complied with throughout its legislation and implementation, and as a neutral taxation, it ought to be a multistage indirect tax generally applied to domestic consumption. For a long time in history, due to specific national conditions, VAT in China failed to be itself but functioned more like a tool grasped by the government. However, in the contexts of both domestic and international economic developments, Chinese VAT is now coming into its own. This is the most important change, since it acts as an internal cause of the former two changes. Up to now, unlike VAT in Europe—which came into being to promote the establishment of a single market and to guarantee the free movement of goods, services, etc.—VAT in China was adopted with the mission of macro-control of the whole national economy. Thus, rather than the pure function of a turnover tax, VAT in China has been more of a label.

To further analyze the transmutation of VAT in China, the inner essence that is hidden in all these changes is the conversion of the focus on the guiding principle—from the principle of efficiency to the principle of neutrality. VAT in China came into being at a time of change of era—from the planned economy era (in which absolute equality was the core pursuit) to the planned commercial economy era (in which high efficiency is the mere pursuit)²⁶⁸. From the perspective of tax, its function as the main source of state revenue was taken seriously for the first time²⁶⁹, meanwhile, its role as an effective tool for national macro-control was still a matter of great importance as it catered to the demands for efficient development. All these factors meant that Chinese VAT at that time was established on the principle of efficiency and much more emphasis was put on the protection of the interest of the state, namely gathering revenue in a fast and simple way.

borne by the BT taxpayer could not be deducted. The existence of double taxation impedes the economic development.

²⁶⁸ The great turning point came into being in 1978, the Third Plenum held in December 1978 decided to shift the focus of the party's work to socialist modernization and economic development has become a priority, the principle of efficiency undoubtedly became the guiding principle.

²⁶⁹ In planned economy era, nationalization was its basic character, and the profits of State owned enterprises was the main source of state fiscal revenue. While in the planned commercial economy era, the reform of economic system (establishment of private business) and the opening up policy (attracting foreign investment and technology) turned the situation completely different and taxation came into view.

The simple and extensive design of the VAT system of that time indeed brought about the rapid development of the economy for a period. Serious problems were faced, however, with the arrival of a new economic era: how to maintain a sustainable and healthy development of the economy from the internal aspect and how to participate better in the competition of the world economy from the external aspect. To deal with the internal and external challenges, the change of the guiding principle is the fundamental countermeasure. The relevant reflection in the VAT field is to shift emphasis from the principle of efficiency to the principle of neutrality (which is the inherent nature of VAT that has long been ignored in China). Thus, the future direction of VAT in China is to rebuild the system into a more neutral design, which implies that the interest of the state no longer has absolute superiority over the interest of the taxpayer²⁷⁰. The right of the latter should be given attention and its intuitive manifestation in the field of VAT is the guarantee of the right to deduct, which is critical to ensure the principle of neutrality. Further discussions about the guiding principle and interest protection for the future of VAT in China are in Chapter 4.

In summary, the VAT system in China is in an era of reform and change, its future direction is to be a modern VAT—a thorough consumptive and neutral tax covering all the areas of production and circulation. To reach this goal, two fundamental issues should be resolved in the first place: one is the shift of the guiding principle from the principle of efficiency to the principle of neutrality; the other is the interest protection, the balance between the interest of the state and the interest of taxpayer should be adjusted. In other words, the previous status—too much emphasis on combating tax fraud and tax evasion while ignoring the right of deduction—should be changed.

2. The ongoing reform to expand the scope of VAT

2.1 The background of the reform

As mentioned above, the “new” VAT system established since 1994 has two parallel types of turnover tax: VAT and business tax (BT). Both of the taxes have their own

²⁷⁰ In fact, the interest of State here was interpreted in a narrow sense, if understood in a broad and long-term perspective, the emphasis of the principle of neutrality is consistent with the interest of State, as it is beneficial to the whole economic development.

areas of application. The scope of VAT is regulated in Article 1 of Interim Regulation of the People’s Republic of China on Value Added Tax²⁷¹: the sales of goods, provision of processing, repairs and replacement services, and the importation of goods within the territory of the People’s Republic of China. The scope of BT is regulated in Article 1 of Interim Regulation of the People's Republic of China on Business Tax: the provision of services as prescribed in the present Regulation, the transfer of intangible assets or the sale of immovables within the territory of the People’s Republic of China. Table 8 presents a brief summary of the scope of the two types of taxes:

Table 8. Scope of VAT and BT compared.

	Scope of VAT	Scope of BT
Sale of goods	Sales and importation of tangible and movable property	Transfer (sales) of intangible assets and immovable property
Supply of services	Processing, repair and replacement services	Transportation, construction, finance and insurance, post and telecommunications, culture and sports, entertainment, services, etc.

Attention should be paid to the fact that both of the Regulations are provisional and promulgated by the State Council. This reflects another important issue, that is the legislation of VAT and for the whole tax system reveals the need to formulate a formal VAT Act and to promote the rule of law in tax field.

Such a system as originally designed has been completely unable to adapt to the current economic situation in China, and has even become a barrier to its economic development. For instance, the imposition of BT poses multi-processes double

²⁷¹ Promulgated by No. 134 Order of the State Council of the People’s Republic of China on December 13, 1993 Amended and adopted at the 34th Executive Meeting of the State Council on November 5th, 2008, and became effective on January 1st, 2009.

taxation on business and encourages vertical integration. Thus, on January 1, 2012, an important initiative of VAT reform began with a pilot program in Shanghai, aiming at replacing business tax (BT) with value added tax (VAT)²⁷². The new round of reformation in VAT is aiming to perfect the VAT system in order eventually to establish a modern VAT system in China. From a macro perspective, the object of the reform is to promote the upgrading of the industrial structure: to support the development of tertiary industry, especially the modern services, and eventually to realize the more stable and healthful development of the whole economy in China. In the current stage of the reform, to reduce the tax burden on taxable persons is one of the periodic goals and is the main method applied to promote the reform.

As mentioned in Chapter 1, there are two prerequisites for a “perfect” VAT system:

- the scope of VAT should be as wide as possible, to cover all business transactions;
- a systematic right to deduct input VAT, with the least possible restriction.

The ongoing VAT reform in China is obviously still focusing on the first of these, which is inseparable from the second one, because to encompass the new areas that were previously taxed by BT, a crucial problem that cannot be ignored is the need for deduction. We can look to Europe which no doubt has made great step ahead in both aspects.

2.2 The detailed processes of the reform

The reform is unfolded in three steps and carried out in two directions. Figure 4 is a diagram of the three steps of the reform:

²⁷² The background for the reform is complicated, from the international financial crisis in 2008 to the domestic Industrial Structure Adjustment. Especially for the latter reason, to extent VAT into the service fields is an inevitable choice for both the improvement of tax system and the promotion of development of tertiary industry.

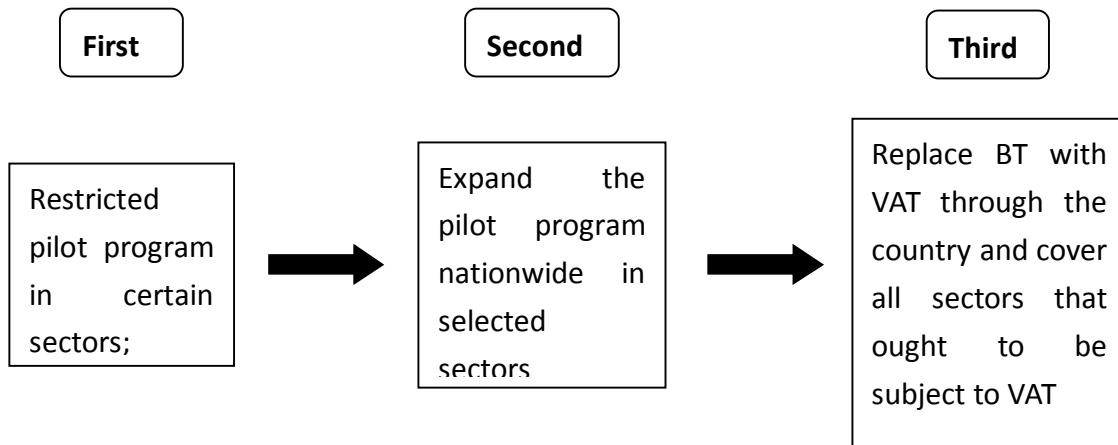


Figure 4. Steps of VAT reform in China.

From these steps we can infer the two directions taken: one is to expand the scope of VAT, that is, to include the sectors previously subjected to BT into VAT; the other is to expand the pilot program and eventually spread the reform nationwide. To push forward in the first direction, treatment of VAT deductions in the newly-encompassed sectors is a crucial part. The second direction requires a reform of the financial system²⁷³ which is not considered in this thesis. Table 9 presents details of the implementation of the ongoing reform.

²⁷³ Since 1994, China has adopted the division-tax financial system, and in which VAT is a central-local shared tax, with a share percent: 75% to the central and 25% to the local; while business tax is a Local tax. Therefore, the extension of VAT to substitute the business tax requires an appropriate financial reform carried out simultaneously

Table 9. Details of implementation of VAT reform.

Time	District	Sectors
January 1, 2012	Shanghai	Transportation* ^① and part of the modern services sectors* ^②
August—December, 2012	Beijing, Jiangsu, An’hui, Fujian, Guangdong, Tianjin, Zhejiang and Hubei.	Transportation* ^① and part of the modern services sectors
August 1, 2013	Throughout the country	Transportation* ^① and part of the modern services sectors
January 1, 2014	Throughout the country	Rail transport and postal services
June 1, 2014	Throughout the country	Telecommunications

*1. Transportation here includes land transport services (temporarily not including rail transport), marine transportation services, air transport services and pipeline transport services.

*2. Part of the modern service sectors here refers to the technical and intellectual services provided for manufacturing, cultural industries and modern logistics industry, including research and development and technical services, information technology services, cultural and creative services, logistics ancillary services, rental of tangible movable property, visa advisory services and media and entertainment services.

The reasons behind the choice of transportation and part of modern services as the first two sectors included in the scope of VAT are: for the transportation sector, it is closely connected to production and circulation of the goods, playing an important role in the productive service industry; and in addition, transport costs are in the scope of the current input VAT deduction

system, freight votes have been included in VAT management system²⁷⁴, which forms a good basis for the reform. With regard to the modern services, first, the modern service industry is an important indicator to measure a country's economic and social development level, to support its development through reform can help improve the overall national strength. Second, to select the part of the modern services which are closely connected to manufacturing industry can mitigate the phenomenon of double taxation arising from industrial division, which is conducive to the development of modern service industry, and favorable to the industry promotion and technological progress as well.

2.3 Transitional measures adopted in the ongoing reform

As aforementioned, the reform was first started in the sectors of transportation and modern services, which were previously subjected to BT at a rate of 3%.

The primary problem in the reform that needs to be resolved is the change of tax burden for the involved sectors. It should not result in an aggravation of the tax burden or at least not too much for the individual taxable person, which is not only beneficial for the reform itself, but is also one of the objects of the whole taxation reform²⁷⁵. During the process, a series of transitional measures are adopted.

2.3.1 Transitional measures

Prior to the reform, VAT rates were set at three levels: standard rate 17%, low rate 13% and a zero rate for exportation. However, to take into account the actual burden of the business tax in the transportation and modern services which are newly included into the scope of VAT, two different rates were added after the practical testing and survey: 11% and 6%. According to Article 12 of Measures for the Implementation of the Pilot Practice of Levying Value Added Tax in Lieu of Business

²⁷⁴ In the VAT system prior to the reform, for the cargo transport services which belongs to the business tax scope, the VAT taxpayer receiving this kind of services could calculate its relative deductible input tax as 7% of the amount on the "road, canal cargo transport unified invoice" issued by the supplier of the transport.

²⁷⁵ One of the motives to carry out VAT reform is to reduce the tax burden of taxpayers on a general base and to prompt the economic development as a whole. Among which, in order to upgrade the industrial structure, the sector of modern services is the primary sector to support, which otherwise, serves seriously repeat taxation (be subjected to BT).

Tax on the Transportation Industry and Some Modern Service Industries²⁷⁶, the rate for supplying leasing services of tangible and movable property is 17%, the rate for supplying transportation is 11%, the rate for supplying modern services (except the leasing services of tangible and movable property) is 6%. This is a countermeasure for a transitional period, and the specific design of the tax rates in the future is not clear for the time being. Nonetheless, simplification of the detailed arrangement is the direction to be taken.

Second, the tax incentive is applied to the newly included sectors. Broadly speaking, the new reduced tax rates as applied to the newly embraced sectors is also a specific form of tax incentives, however, there is another typical form being adopted, which is highlighted here. It is the “immediate refund upon payment” (in Chinese, *Ji zheng ji tui*), which means the tax authority first levies VAT in full, then all or part of it will be refunded to the taxpayer regularly by the tax authority.

The sectors involved are:

- ◆ The part of the already levied taxation which is over 3% of the actual tax burden of the general taxpayer providing pipeline transportation services;
- ◆ The part of the already levied taxation which is over 3% of the actual tax burden of the general taxpayer providing financial leasing of the tangible and movable property.

This is because, prior to the reform, the rate of BT charged on the relative sectors was 3%.

Along with the deepening of the reform, there are calls to include new sectors into the scheme, such as the transportation sectors. In my view, this is a quite questionable arrangement, and the specific type of taxpayer being included should be considered carefully.

The last measure that should be mentioned is the optional choice between the general collection method and a simplified collection method for the general taxpayer of the

²⁷⁶ The document was issued on May 24, 2013 by the Ministry of Finance and State Administration of Taxation in No. 37, including 53 provisions in 8 chapters in all. It is effective from August 1, 2013, meantime, the document in charge with the same issue, which was issued on November 16, 2011 was abolished.

newly included sectors. By the latter method, the newly included general VAT taxpayer is assessed at a lower tax rate²⁷⁷ on sales without the deduction of input tax, just like a small-scale VAT taxpayer. At present, VAT taxpayer of the two items below can make such a choice²⁷⁸:

- ◆ Provider of public transportation services;
- ◆ Provider of leasing services with subject matter which was purchased or homemade prior to the date of the reform being introduced.

2.3.2 Problems resulted from the transitional measures— a perspective of VAT deduction

Although the aforementioned are just transitional measures, which means they are not general and permanent arrangements, they still bring about problems to the function of the whole VAT system, which is reflected obviously by the work of VAT deduction—to break the integrity of the chain of deduction.

First, there is the complicated arrangement of tax rates. It is a common sense that, in theory, the simpler the VAT rate arrangement, the better it can play its proper role. Notwithstanding the fact, in practice, for political and other factors, it could not be imposed at a uniform rate, the status of the newly added two tax rates applied respectively to the new sectors shall still be promptly changed. The diversity of the tax rates leads to the incomplete of deduction in certain sectors. This, in addition, results in an unfair competitive environment in the market and pose a threat to the principle of neutrality, which, otherwise, is ensured by the deduction chain of VAT.

Second, there is the mentioned special type of tax incentive applied, immediate refund on payment, which not only poses additional administration pressure on the tax authority, and obviously runs counter to current collection capacity in China, but also leaves space for taxable persons to carry out tax evasion or tax fraud²⁷⁹.

²⁷⁷ The levy rates for VAT general taxpayer who select the simplified method 6% or 4% based on the sectors they belong in.

²⁷⁸ The selection of the taxpayer who can make the choice is based on the consideration of the limited deductible input VAT of them.

²⁷⁹ This type of tax incentive is not only applied in the reform, it exists much earlier for the software enterprises in VAT field. And its implementation in practice resulted the above mentioned problems as well. Therefore, the adoption of this measure is quite questionable, at least, the time period for its

Last, the option of a simplified collection method for the newly included general taxpayer breaks the chain artificially, as no deduction is confirmed, and this is quite contrary to the original intention of the reform. Especially, for the general taxable person who carried out mixed business (both those previously subjected to VAT and the newly included ones), and additional management costs will be brought about. This is a measure with Chinese characteristics, a way to release the possible aggravated tax burden of the involved taxpayer on the basis of the limited collection capacity. However, the adoption of this extreme special measure makes the already complicated VAT system even more complex. Besides the different collection methods applied based on the distinction of taxpayer type—general VAT taxpayer and small-scale VAT taxpayer—, both of the different collection methods can be applied to the general VAT taxpayer, which is a great pressure for both the tax authority and the taxpayer.

2.3.3 Personal thoughts and suggestions

Based on the problems discussed above, in this section I give my own opinions about the transitional measures and the possible alternatives or changes to be made in the future. First of all, I would like to ask, what is the real reason for the adoption of the “inappropriate” transitional measures? As far as I am concerned, besides the fact that there is an actual need for some special sectors at such a transitional stage, it is seriously influenced by the deviation from the original intention of the reform. In other words, in the match between the direct reason and the original intention, too much attention is put on the relief of the possible aggravated tax burden, while ignoring the original intention of the reform, which is to expand the scope of VAT in order to complete the chain of deduction, by which to eliminate the repeat taxation caused by BT, and to promote economic development as a whole. The reduction of

adoption should be limited. Personally speaking, I am not in favor of its adoption, alternatives are available, such as the mentioned reduced tax rate or any other form of tax incentives.

the tax burden might be an important approach to promote the reform, however, it should not be an element that outweighs the original intention of the latter²⁸⁰.

Second, is there is a genuine necessity for the mentioned transitional measures? Regarding the detailed transitional measures, the main reason to favor their adoption is the possible aggravation of tax burden for those newly included taxpayers by, on the one hand, raising the tax rate (from 3% to 11% or 6%) and, on the other hand, the limited deductible amount of the input tax for certain sectors. In my view, this problem is over-considered. For the first point, the increase of rate does not necessarily lead to the tax burden increasing, as the tax base is not the same. The previous BT was charged on the basis of the sales, however, the actual tax base for VAT is the added value of the products. For the second point, it is true for some enterprises in certain sectors that the tax burden has been increased, such as the enterprises with the assets purchased before the reform (the deductible amount of input tax is very limited). However, for the other enterprises, the limited input VAT deduction is caused by their own extensive management, with no unified management for the deductible bills. Thus, the adoption of the transitional measures should be based on a careful distinction.

Finally, based on the above discussion, I make two points of suggestions for the ongoing reform. First, other than adding different tax rates for the newly included sectors, the tax rate of the whole VAT system should be rearranged based on the data provided by the reform. One fact must be admitted—it is not possible and also not necessary to reduce the tax burden totally for all the involved sectors. From another perspective, it is not appropriate to include the new sectors in the already existing tax rate arrangement, or to impose VAT with a unified rate in the current situation. Therefore, currently, I am in favor of three sets of rates: standard rate, low rate and

²⁸⁰ Although, as expressed in the previous part (the backgrounds of the reform), the reduction of the tax burden of taxpayer is also one of the objects of the reform, it should not be the factor considered over the initial intention, as the latter is the factor to decide the basic direction taken.

zero rate²⁸¹. The exact percentages should be decided on the basis of data from practice and economic surveys as well.

Second, all the transitional measures should be reorganized based on the careful investigation of the specific circumstance of the enterprises. In particular, the authorization of the tax incentives should be based not only on the sector to which an enterprise belongs, but also on the special conditions of that enterprise. I admit that in such a transitional stage special measures should be adopted to resolve the new problems resulting from the reform. In order to prompt the reform, the basic principle is not to aggravate the tax burden for the involved taxable person. However, the most important object of the reform is to promote the upgrading of the industrial structure, that is to say, the management style or approach of every single enterprise should be adjusted as well. However, as mentioned, the adoption of some transitional measures has not taken consideration of this point, which will result in a contrary effect.

In all, the original intention of the reform shall be borne in mind throughout the reform, of which the guarantee of the integrity of VAT deduction is the core, and the measures taken should be tested seriously under this principle.

3. Chinese treatment of VAT deduction in certain situations

In the context of the VAT system described above—undergoing a series of reforms to modernize it—VAT deduction is in a stage of changing and its exercise in most situations needs to be adjusted.

3.1 VAT deduction in the situation where a taxpayer acquires “falsely issued” invoices

To better understand the topic discussed, the term “falsely issued VAT invoice” should be explained first, as it should not be understood literally. The “falsely issued VAT invoice” here means that the VAT invoice acts like a tool to carry out tax fraud, thus it becomes “falsely issued” due to the illegal motivation or action of its issuer. It does

²⁸¹ The adoption of tax incentives is unavoidable as well at present, actually, this is a worldwide challenge or problem faced in the VAT field. One exception is the VAT system in New Zealand, a system being viewed as the closest to a perfect one.

not refer to the case that the VAT invoice is recorded with incorrect numbers; its contents might be fully consistent with the actual transaction carried out. It is quite a Chinese saying of the situation, in which a taxable person is involved in a case of tax fraud innocently, then his relevant right of deduction should be impacted or not. Putting aside the relevant European rulings on this issue, which will be described later, the Chinese treatment of VAT deduction in this situation is given first.

3.1.1 How it is ruled in the regulations

Concerning the regulation of this issue, there are four documents with three positions. All the documents were promulgated by State Administration of Taxation. Among them, Circulars No. 134²⁸² and 182²⁸³ define the nature of exercising the right to deduct by “falsely issued” VAT invoice as tax evasion or tax fraud. Circular No.187²⁸⁴ then serves as a complement to the former two. It came into being to provide a different treatment in a special situation—where the “falsely issued” VAT invoice is acquired in good faith (without acknowledgment), the detailed contents of which will be stated later. Last the most recent is Announcement No.33²⁸⁵ which just expresses briefly and definitively that falsely issued VAT invoices received by the taxpayer cannot be legal and effective certification of its right to deduct VAT.

Among the four documents, Circular No.187, which distinguishes the special situation where the “falsely issued” VAT invoice is acquired in good faith, from the general situation of the knowing acquisition of a “falsely issued” VAT invoice, establishes a different treatment. Therefore, the decision of whether the falsely issued VAT invoice is acquired in good faith or not becomes the crux of dealing with the situation in question.

²⁸²Circular of the State Administration of Taxation on the Settlement of the Taxpayers Obtaining the False Special Invoice of Value-added Tax, 08/08/1997.

²⁸³Supplementary Circular of the State Administration of Taxation on the Circular of the State Administration of Taxation on the Settlement for the Taxpayers Obtaining the False Special Invoice of Value-added Tax, 06/11/2000.

²⁸⁴Circular of the State Administration of Taxation on the Settlement for the Taxpayers Obtaining the False Special Invoice of Value-added Tax without Acknowledgement, 16/11/2000.

²⁸⁵Announcement of the State Administration of Taxation on the Supplementary Levy Taxation of the taxpayer who falsely issued Special Invoice of Value-added Tax, 09/07/2012.

From my point of view, the substantial conflict in the situation where a taxpayer acts in good faith is that between the interests of the taxpayer and the interests of the state (the state's revenue). The key to solve the problem is to find a proper balance between the two parties. On this topic, Europe and China take different directions, or in other words, the balance point is located differently. I will begin with the current treatment of this situation in China, to see how the balance is made in China.

As just mentioned, the document that in particular regulates the treatment of VAT deduction in the situation where a taxpayer acts in good faith is the "Circular of the State Administration of Taxation on the Settlement for the Taxpayers Obtaining the False Special Invoice of Value-added Tax without Acknowledgement" (Circular No. 187), which was promulgated in 2000 by the State Administration of Taxation. Four elements of "in good faith" are listed and all these elements should be met at the same time:

- The existence of a real transaction;
- The VAT invoice is issued by the seller and its contents are consistent with the actual transaction;
- The invoice issued is acquired in the province where the seller is established²⁸⁶;
- There is no evidence indicating that the buyer knows (or should have known) that the invoice is obtained by illegal means.

Seeing the four elements listed, the first three elements are in an effort to prove that the invoice is not faked on purpose or be issued by the third party, otherwise we can obviously exclude the possibility of "in good faith", the fourth element just to further confirm the situation from a negative perspective.

Meanwhile, the legal results, once "good faith" is assured, are also provided in this notification:

- The buyer (the acquirer of the falsely issued VAT invoice) is not to be punished for tax evasion or export rebate fraud;

²⁸⁶ This element is relative to the handwritten VAT invoices. In fact, with the nationwide spread of VAT tax control system, as most of the enterprises are included, this element can always be fulfilled.

- Input tax shall not be deductible or export tax rebates not granted;
- The input VAT already deducted or export tax rebates already acquired should be recovered by law;
- The deductible input VAT or export tax rebates shall be allowed by the tax authority under the following conditions: the buyer can regain legal and valid VAT invoices out of “tax security control system” from the seller or the buyer acquires proof that the seller is under investigation the local tax authority for falsely issuing VAT invoices.

Seeing the legal results, the conclusion might be made as such, first, in general, the receiver of a falsely issued VAT invoice cannot exercise the right to deduct connected to that invoice; second, the right to deduct can be regained under certain conditions. Putting aside the difficulties of fulfillment, we discuss the purpose behind them first. In fact, both the conditions imply that the right to deduct connected to a falsely issued VAT invoice can be exercised by one who receives it in good faith, only on the condition that the output VAT contained on that invoice has been already or will be submitted to the tax authority. In other words, the tax revenue of a state has absolute priority over the taxpayer’s right of deduction.

To repeat, before the promulgation of Circular No. 187, two other circulars had been released by the Administration of Taxation, Circular No. 134 in 1997 and Circular No. 182 in 2000, aiming to combat the tax frauds carried out by the method of issuing VAT invoices, either by the fake numbers recorded on the invoices or by the illegal acquisition of the issued invoices at the beginning. According to which, the purchaser who exercises its right to deduct on the basis of the falsely issued VAT invoice (for example, issued by the third party) is regarded as carrying out tax evasion or tax fraud and should be subject to a fine and late payment surcharge²⁸⁷.

Now, we make a conclusion of all the above-mentioned regulations from the perspective of the right of deduction, as presented in Table 9.

²⁸⁷ Both the documents display an obvious inclination to the interest of state, as the taxable person involved is supposed to be in bad faith, and the burden of proof is moved to the taxpayer. This is one of the basic defects in Chinese VAT system.

Table 9. Detailed contents of the related documents

Documents	Right of deduction	Other legal results
Circular No. 134 and No. 182	No such right, and in addition if the receiver exercises its right to deduct which is based on the ‘falsely issued’ VAT invoice, such action is viewed as conducting tax evasion.	Administrative penalty: fine and late payment surcharge; and Even criminal penalty if the amount deducted exceeds a certain value.
Circular No. 187	In general no such a right, but it could be regained under certain conditions.	Free of administrative and criminal penalties
Announcement No. 33	No right to deduct no matter whether the ‘falsely issued’ VAT invoice is acquired in good faith or not.	No relative contents.

Obviously, in China, the balance between the interest of the state and the interest of the taxpayer is quite inclined to the former. How then will the situation be in practice based on the regulations inclined totally to the interest of state?

3.1.2 The detailed implementation in practice

For this part, two model cases, which are typical in China, will be given and discussed. The detailed and actual treatment of the cases could well reflect the flaws and remaining problems of the issue in question—VAT deduction in the situation where a taxpayer acquires a ‘falsely issued’ VAT invoice.

Case 1

In March 2000, Company A in Province X acquired 100 VAT invoices from the tax authority and disappeared immediately. Then, Company B in Province X sold goods to Company M which was established in Province Y. In an attempt to avoid tax,

Company B bought ten VAT invoices from Company A, and issued them in its own name to Company M without accounting for them (no declaration of tax return for the 10 VAT invoices). Company M claimed that it had no knowledge of Company B's illegal acquisition of the VAT invoices.

Case 2

In May 2011, Company N concluded a contract with Company B for the supply of pipelines, Company B issued six VAT invoices in total to Company N in this transaction, and declared all of the invoices in its tax return. Company N also included those invoices in its tax return and exercised its right of deduction. During the inspection of Company B, the tax authority found out the fact hidden behind the foregoing transaction: Company A (not a general VAT taxpayer, no right of issuing VAT invoices) was the true supplier of the goods sold to Company N in the name of Company B, it bought VAT invoices from Company B with a fee of 7.5% of the cost of the goods (including VAT). Company N made its payment to Company B, and Company B transferred it to Company A after subtracting the fees. Company N claimed that it had no knowledge of the fraudulent action of Company A and Company B.

In practice, both Company M in case 1 and Company N in case 2 are viewed as taxpayers acting in good faith. But with the national coverage of the VAT Anti-Fake and Control System²⁸⁸, case 1 can hardly happens any more. Therefore, I will discuss case 2 further. Prior to the promulgation of Announcement No. 33, Company N in case 2 was always viewed as “in good faith”. However, the problem is that it cannot be acting in good faith if strictly put it into checked according to the requirements ruled in the Circular No. 187 mentioned above, as element 2—the VAT invoice is issued by the seller and its contents consistent with the actual transaction—could not be satisfied. But why it was still viewed as “in good faith” in practice?

²⁸⁸ Since 2011, the handwritten VAT invoice was no longer valid, and in the system, only the registered taxable person could issue VAT invoices with a unique Tax ID.

The reasons could be inferred from the Circulars per se (see section 3.1.3) and in addition, the puzzling treatment in practice precisely reflects the remaining problems in Chinese VAT deduction.

3.1.3 Analyses of the Chinese treatment and the remaining problems

The question in case 2 is how to define Company N's action, in good faith or not? There are two choices available under the regulations: conducting tax evasion (according to Circular No. 134 and No. 182) or acting in good faith (on basis of Circular No. 187). With the obvious failure by Company N to fulfill the elements of good faith, the tax authority faced a dilemma: an apparent injustice to Company N by deciding it had conducted tax evasion and not sufficient to identify Company N in good faith. More detailed discussions of this problem follow.

3.1.3.1 The dilemma caused by the current regulations

From the regulations we can infer that China makes the balance between taxpayer and national revenue inclined rather to the latter. This is because:

According to the current regulations, the recipients of “falsely issued” VAT invoices can be divided into two groups: either as a conductor of a tax evasion itself or one who acts in good faith. The main different result between the two groups is whether the recipient should bear the administrative penalties (or in some serious cases should be held criminally responsible).

With regard to the right to deduct, even if the recipient is confirmed as “in good faith”, its exercise of the right is subject to certain conditions. And by looking back the two conditions in Circular No. 187, we can find that the substantial precondition for the exercise of the right of deduction as the threat of revenue loss has been omitted. In addition, the two conditions listed can scarcely be fulfilled in practice. Which, I have to say, is rather unfair to the taxpayer.

Back to case 2, it was rather difficult for the tax authority to make a decision, as from one aspect it is apparently unjust to regard Company N as a conductor of tax evasion (in fact, this is the correct treatment according to Notification No. 134 and No. 182), and from the other aspect, Company N could not fulfill the requirements listed in

Circular No. 187 to be affirmed as in good faith. In the balance of the subsequent consequences, the tax authority chose the latter one, which is not completely in accordance with the provisions of Circular No. 187. Therefore, to break the dilemma, an announcement was made by the State Administration of Taxation in 2012 (Announcement No. 33²⁸⁹), in which it expressed briefly that falsely issued VAT invoices received by the taxpayer cannot be legal and effective certification of its right to deduct VAT. The announcement excludes deduction of VAT from a ‘falsely issued’ invoice regardless of whether the taxpayer acts in good faith or not. So now, in practice, in front of the cases similar to the case 2 expressed above, the tax authority always makes reference to Announcement No. 33 to exclude the taxpayer’s right to deduct without deciding whether the taxpayer acts in good faith or is avoiding tax, as this seems like the most reasonable decision that the taxable person could accept. However, from a logical perspective, the clue of the legal construction of this issue seems a retrogression, as the distinction of a specific situation—in good faith—is excluded, which otherwise should be considered seriously in a good and complete system. Thus a direct and obvious conclusion is that the current system of treating the issue in question is quite problematic.

3.1.3.2 Remaining problems and proposals

With the description of the “superficially” reasonable treatment of VAT deduction in the current VAT system, concerns about the improvement and changing of the system arise spontaneously.

(1) The problems remaining

Up to now, the regulative system of VAT deduction in relation to the “falsely issued” VAT invoices is mainly composed of the four documents mentioned above. In their detailed implementation in practice, we find that they contradict each other in their contents and their rationality is pending scrutiny. Thus, I draw my own conclusion on the problems in the current system dealing with VAT deduction in the situation of

²⁸⁹ In fact, this Announcement is not specified for dealing with the decision of the nature of action Company N alike, but focus on the recovery of VAT liability recorded on the ‘falsely issued’ VAT invoice.

acquiring “falsely issued” VAT invoices. This is just a personal idea and will not necessarily be explored exhaustively.

First, on the surface, the lack of consistency and contradictory contents among the regulations makes them difficult to implement properly and even poses a threat to the principle of legal certainty. The difficulty in practice mainly results from the requirements in Circular No. 187 for “in good faith” and the either-or-style classification, which means the purchaser who receives a falsely issued VAT invoice liable to be classified either as one acting in good faith (who did not know or should not have known the truth that the invoice was falsely issued) or one who has carried out tax evasion. No intermediate zone exists. The deep reason behind the design of this system is the wrong direction we take, that is, to presume the taxable person (who receives a “falsely issued” VAT invoice) is in bad faith at the beginning, and should be punished not only with denial of the right to deduct, but also an administrative penalty and even criminal penalty as well. And the existence of the problem that there is no guarantee of the right to deduct and the sentence in the latter case (tax evasion), makes the legal results of failing to be in good faith rather grave to the taxpayer, which is apparently unjust and unacceptable for the taxpayer. Still further statement of this problem is that whether the taxable person should be supposed ‘in good faith’ or ‘in bad faith’ from the very beginning. Obviously, the system in effect in China at present makes the choice the latter one, of which I am not in favor. Thus the “illegal” but reasonable (or rather relatively acceptable) decision is made by the tax authority in practice, however, this is far from the correct choice and a fundamental solution needs to be found.

Second, there is a deep-seated problem I have already mentioned—too much inclination to the interest of the state²⁹⁰, in other words, excessive emphasis on

²⁹⁰ The counterbalance between the interests of the state and the taxpayer might not be a question in Europe, or this issue is considered on a rather high level, but in China, because of the special history, it is an issue should be considered seriously, and the adjustment of the balance between them should be made carefully. Actually, the protection or emphasis of the interest of taxpayer is realized by both the scholars and the authorities, while it is a long process to put it into in the legal system and practice. To be furthered, this is relative to the question—what is the essence of the taxation, and in the relationship of the tax authority and taxpayer, in what a position should be fixed for both the two parts, in the sphere of public law or private law.

combating tax evasion and tax fraud while ignoring the principle of neutrality in VAT. The most important reason for saying this, is that, in practice, as long as one receives a “falsely issued” VAT invoice, the connected right to deduct is denied notwithstanding whether the recipient is “in good faith” or not (it is presumed to be in bad faith in the first place).

This significant defect has been further reflected by the harsh conditions imposed on a taxpayer who has been affirmed as acting in good faith to exercise its right to deduct input VAT. The result is, no matter whether in good faith or not, the recipient of a “falsely issued” VAT invoice could not exercise its right to deduct in practice, which is not in line with the legal character of VAT in itself. What then might be the possible remedies for the expressed problems? The following are my personal thoughts on the possible remedies to the remaining problems in this situation.

(2) Proposals

As far as I am concerned, to provide a fundamental solution, the existing system should be rebuilt completely. Prior to this, a set of concepts and the relationship between the interest parties should be clarified in the first place.

First, what does a “falsely issued” VAT invoice mean? As mentioned, the “falsely issued” VAT invoice is not restricted to the improper writing errors made (such as the incorrect number), but refers to the invoice being exploited as a tool to conduct tax fraud, notwithstanding the fact that, in some cases, the contents of the invoice might be identical with the actual transaction. On this point, I am concerned that it might be better to rename the indicated invoice in order not to avoid misinterpretation, such as “fraudulent VAT invoice”.

Second, what are the principles to obey and the interests to protect in this conflict? As already noted, more emphasis should be put on the neutral nature of VAT in today’s China, therefore, the most fundamental principle is the principle of neutrality—which has long been sacrificed to some extent in the previous periods. From this point, the right of deduction—the “soul” of the deductive chain (a critical mechanism of assuring VAT’s neutral character)—ought to be granted to the greatest extent. From

the perspective of interests protection, to grant the right of deduction indicates that the balance between the interest of State and the interest of taxpayer should be adjusted. Broadly speaking, there is no substantial contradiction between them, as the equitable and freely competitive environment “safeguarded” by the neutral nature of a turnover tax is essential to the proper functioning of a state’s whole economy. It is unavoidable that the right of deduction might be taken advantage of and for the taxpayer with ulterior motives to take advantage of its flaws to carry out tax fraud. However, to combat the wrongful acts one could not simply adopt the one-size-fits-all approach, and this is the exact issue to which shall we pay special attention and now make great efforts to resolve.

Based on the above, my proposal is shown graphically in Figure 5.

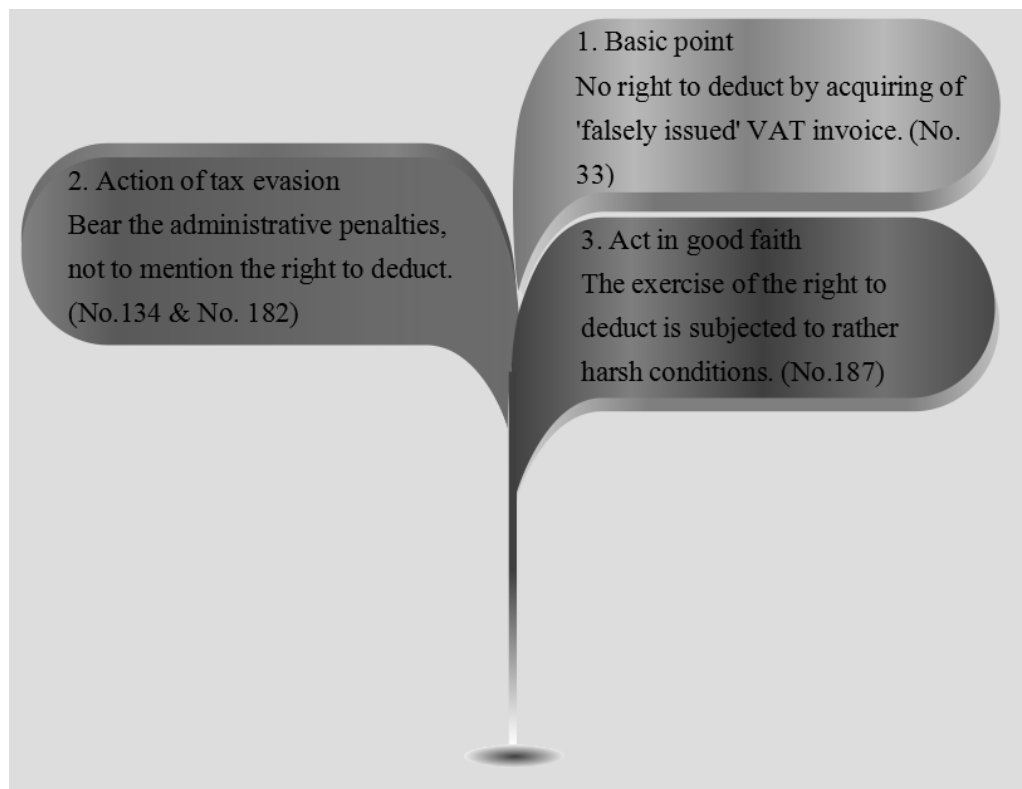


Figure 5. Personal recommendation of appropriate solution

Figure 5 indicates that the starting point is the taxpayer’s acquisition of ‘falsely issued’ VAT invoices. Then the mere fact of acquisition could go in two directions could: conduct tax evasion or only act in good faith. The difficulties and the main

problem are how to decide the right direction of the acquisition action (the legal feature of the action) and what are the proper legal results the taxpayer should bear.

The mentioned and regulated two directions—tax evasion and ‘in good faith’—are the choices, but the direction taken should be decided on objective evidence and in addition, from my opinion, there should be an intermediate zone between the two directions, under the condition that there is no convincing evidence to make the decision between the directions. That is the start point—the acquisition of the “falsely issued” VAT invoice and its relative legal results should be stipulated as well.

3.1.4 A brief comparison with Europe in the same situation

The discussion of the similar situation in Europe is ongoing as well. It is a real legal issue in practice, but with no specific term to address it.

3.1.4.1 Judicial practice in Europe of this situation

The relevant decision of the ECJ is in the joined cases *Mahagében kft v. Nemzeti Adó- és Vámhivatal Dél-dunántúli Regionális Adó Főigazgatósága (Mahagében)* and *Péter Dávid v. Nemzeti Adó- és Vámhivatal Észak-alföldi Regionális Adó Főigazgatósága*²⁹¹. For the sake of the discussion, the basic facts in *Mahagében* are that Mahagében bought wood from a company (C), the invoice was issued properly (no formal problem). The tax authority examined Mahagében and—in a connected procedure—C and, established the fact that C had no wood at the time of the sale. There are several similar situations in the market, when the contractor has no capacity or competence to provide the service concluded in the contract. The question is whether the tax subject (customer/Mahagében) was/is entitled to deduct input VAT. The similar situation occurs frequently in construction contracts (*Péter Dávid* was such a case). In a normal case, under a construction contract, the contractor is obligated to perform building and installation work and the customer is obligated to accept delivery of and pay the contracted fees for such work. The contract is performed, the contractor issues the

²⁹¹ Cases C-80/11 and C-142/11, the tax authority in Hungary references for a preliminary ruling of refusal of the right to deduct in the event of improper conduct on the part of the issuer of the invoice relating to the goods or services in respect of which the exercise of that right is sought, it is related to the national measures to combat VAT fraud and its practical problems.

invoice (fee+VAT) and the customer pays the counter-value. The customer as a tax subject is entitled to deduct VAT which it has paid to the contractor. However, during an ordinary inspection or during the inspection carried out before disbursement, the tax authority finds that the taxpayer was/is not entitled to the tax deduction or tax refund requested, in other words, the contractor had no capacity (engineers, workers, equipment, etc.) to meet the requirements stipulated in the contract²⁹². In brief, the reality is that the parties concluded a contract, however someone else performed it instead of the contractor, and there is no document about the existence and the activity of the real performing subject (see Figure 6).

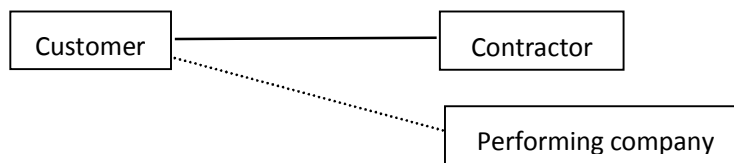


Figure 6. Subjects involved

This is quite similar to the model case 2 described above in China. However, according to the ECJ's judgment²⁹³, the result is quite different from the former. In paragraph 66 of the judgment, it stated,

Articles 167, 168(a), 178(a) and 273 of Directive 2006/112 must be interpreted as precluding a national practice whereby the tax authority refuses the right to deduct on the ground that the taxable person did not satisfy himself that the issuer of the invoice relating to the goods in respect of which the exercise of the right to deduct is sought had the status of a taxable person, that he was in possession of the goods in question and was in a position to supply them, and that he had satisfied his obligations as regards declaration and payment of VAT, or on the ground that, in addition to that invoice, that taxable person is not in possession of other documents capable of demonstrating that those conditions were fulfilled, although the substantive and formal

²⁹² Its most simplest way is that it is almost a shelf company.

²⁹³ ECJ, 21 June 2012, Case C-80/11, *Mahagében Kft v Nemzeti Adó- és Vámhivatal Dél-dunántúli Regionális Adó Főigazgatósága* and Case C-142/11, *Péter Dávid v Nemzeti Adó- és Vámhivatal Észak-alföldi Regionális Adó Főigazgatósága* [2012].

conditions laid down by Directive 2006/112 for exercising the right to deduct were fulfilled and the taxable person is not in possession of any material justifying the suspicion that irregularities or fraud have been committed within that invoice issuer's sphere of activity.

The reasons for this decision can be found in the judgment per se, especially paragraph 57 of the judgment, “the measures which the Member States may adopt ... must not go further than is necessary to attain such objectives. Therefore, they cannot be used in such a way that they would have the effect of systematically undermining the right to deduct VAT and, consequently, the neutrality of VAT, which is a fundamental principle of the common system of VAT.” Up to now, the different attitudes held by the ECJ and the Chinese tax authority are quite clear, which just provides concrete evidence of my previous thoughts about the remaining problems in the Chinese VAT system²⁹⁴—although the principle of neutrality is realized generally, it is insufficiently reflected in the legal system and its practice as well.

3.1.4.2 The German situation

At the international seminar on contemporary challenges to European tax law (in comparison to the US system), which was held in Budapest in 2015, I had the opportunity to further understand how the issue was treated in Germany, Hungary and Italy. Among these, the regulatory regime and its judicial practice in Germany inspired me the most, in addition, since in the beginning of the adoption of VAT in China, we made main reference to the VAT system in German, here I'd like to demonstrate the relative treatment in German in details.

The conditions to demand VAT deduction are regulated in Article 15 of UStG (*Umsatzsteuergesetz* = Turnover Tax Act), which provides the objective conditions explicitly: (1) Delivery of goods or performance of service; (2) Conducted by the

²⁹⁴ I am not saying that the European method on this issue is perfect, as a matter of fact, serious problems are faced in Europe as how to combat VAT fraud in a proper way by the Member States. And out of this reason, a serious of cases were delivered to ECJ to refer for a preliminary ruling. And some of the scholars are thinking about to list the due diligence for the 'customer' to obey in a transaction. This is still an open question. In fact, the list of elements to be 'in good faith' stipulated in Chinese Notification might be an inspiration for Europe, but its detailed contents need to be reconsidered under the principle of neutrality and equality.

contractor; and (3) A valid invoice. There is also an unwritten subjective condition—good faith²⁹⁵. Table 10 shows whether the taxable person could exercise the right of deduction in different situations:

Table 10. Right of deduction treatment in different situations

Subjective Conditions Objective conditions	Fulfilled	Not fulfilled
Fulfilled	1. Conditions fulfilled & good faith → VAT deduction	2. Conditions not fulfilled & good faith → VAT deduction only through equity-based process possible
Not fulfilled	3. Conditions fulfilled & bad faith → No VAT deduction	4. Conditions not fulfilled & bad faith → No VAT deduction

Two questions arise in practice: one is, who bears the burden of proof regarding the conditions of VAT deduction in accordance with § 15 UStG; the other is how the condition of good faith can be determined. This is a problem faced in European VAT, and according to the ECJ’s case-law, for the first question, the answer is: in general, the tax authority bears the burden of proof regarding the rebuttal of the unwritten condition of good faith in the sense of § 15 UStG²⁹⁶. However, one should distinguish between the objective conditions and subjective conditions, for the former, it is the

²⁹⁵ This is an element being considered in practice, but not expressed in detailed provisions.

²⁹⁶ As ECJ stated in its judgment in Mahagében and Dávid, C-80/11 & C-142/11, in para. 49: “Given that the refusal of the right to deduct ... is an exception ..., it is for the tax authority to establish ... the objective evidence which allows the conclusion to be drawn that the taxable person knew, or ought to have known, that the transaction relied on as a basis for the right to deduct was connected with fraud committed by the supplier or by another trader acting earlier in the chain of supply.” The deep reason behind this statement is, a tax authority must not transfer its own control obligations to the taxpayer. Again, here reflects a basic point of view of the protection of the right of taxpayer in Europe, which is just the point being neglected in China.

burden of taxable person to prove the conditions are fulfilled, while, for the latter, under the precondition that the objective conditions are fulfilled, it is the tax authority's burden to prove that the taxable person "knew, or ought to have known, that the transaction relied on as a basis for the right to deduct was connected with fraud". For the second question, no indicators are given in law, but some indicators are applied by the tax authority²⁹⁷.

We can see that, in the balance between tax authority and taxpayer, Europe and China take contrary directions, obviously, both of them face problems with their choices: for Europe, a huge flaw is resulted in cases that the taxpayer has conducted tax fraud; for China, it is the sacrifice of the principle of neutrality in VAT. In my view, I favor one solution—to provide a list of due diligence criteria for a taxpayer to fulfill in a transaction, in order to relieve the tax authority's burden of proof of good faith to some extent. Then the core of the question is what elements should be on that list²⁹⁸. This is what I am considering now. But it is quite clear that, China should make changes to address this problem, and this is a chance for China to avoid new problems in face of the experience of Europe.

3.2 VAT deduction of preparatory activities

In the current VAT system in China, VAT deduction of preparatory activities is not a typical issue taken into consideration, but, on the contrary, it is considered seriously in Europe. According to the Chinese tax procedure law²⁹⁹ in effect, a newly established enterprise should apply for tax registration within a certain period after its receipt of

²⁹⁷ Here are some criteria used by a German regional tax authority: 1) The carrier company was founded recently or just started its market activities; 2) The carrier company is unknown within the market segment; 3) The carrier company offers amounts of products which are unusual for its size or/and its lack of experiences in the market segment; 4) The carrier company does not have any or proper storage rooms or has charged a forwarding agency with the storage of the products. The problem is how could or should a company know the facts listed above? Thus, these indicators are only used by the administration and are not affirmed by a court.

²⁹⁸ Here are some elements I am considering: (1) The issuer of the invoice has the status of a taxable person ; (2) He is in possession of the goods in question; (3) He is in a position to supply them; (4) He has satisfied his obligations as regards declaration and payment of VAT, etc. Actually, for the former three elements, they are basic requirements for in civil law for a subject to enroll into a contract. And the last element seems a little over according to me.

²⁹⁹ Law of the People's Republic of China Concerning the Administration of Tax Collection (2013 Amendment) (hereinafter Law Concerning the Administration of Tax Collection), and Rules for the Implementation of the Law of the People's Republic of China on the Administration of Tax Collection (2012 Revision).

business license³⁰⁰, normally within 30 days. Preparatory activities refers to certain works used for the purpose of an economic activity which at the time at which VAT was incurred had not yet given rise to any output supplies of goods or services. It could occur before or after the formal establishment of an enterprise. The crucial argument for the deductibility of the input tax connected to such preparatory activities is the principle of inherence, which means the products purchased which bore the input tax must be put into the actual taxable economic activities. In China, this is an essential element for VAT deduction, thus no VAT deduction is available for the preparatory activities.

While, in principle, the ECJ is in favor of VAT deduction for preparatory activities³⁰¹, basically out of the consideration of the principle of neutrality—the VAT deduction system is meant to relieve the trader entirely of the burden of VAT paid in the course of all his economic activities³⁰². The argument is normally around how to judge the initial purpose of the taxable person in order to avoid the possible tax fraud or tax evasion carried out by taking advantage of this attitude of the ECJ.

Apparently, on the issue of VAT deduction for preparatory activities, the requirement of inherence is more important than the principle of neutrality in the Chinese VAT system, which is quite different from the treatment in Europe. The latter treatment faces other problems, however, of tax fraud or tax evasion, which again reflects the adjustment of the balance between the neutrality of VAT and the combating of tax fraud. What should be the principle to find an appropriate fulcrum in the balance? In my view, the decision should be made according to the legal character of VAT, which

³⁰⁰ It is provided in Article 15 of the Law Concerning the Administration of Tax Collection, which states: “Enterprises, branches in other localities established by such enterprises, sites engaged in production or business operations, individual businesses as well as public institutions engaged in production or business operations (hereinafter referred to as “taxpayers engaged in production or business operations” collectively) shall, within 30 days after receipt of the business license, apply for the tax registration with the tax authority by producing the relevant documents. The tax authority shall conduct registration formalities and issues tax registration certificates on the same day of receipt of the application.”

³⁰¹ In this matter, the attitude was consistently reiterated by the ECJ, that a taxable person is entitled to deduct VAT payable by him on goods or services supplied to him for the purposes of being used in connection with taxable transactions, even where for reasons beyond his control they were not used for that purpose, or those taxable transactions did not take place, see cases C-37/95, *Ghent Coal Terminal*, [1998] ECR I-00001; C-110/98, *Galbafrija and others*, [2000] ECR I-1577, etc.

³⁰² See Michael Lang et al., “CJEU—Recent Developments in Value Added Tax 2014”, Linde Verlag GmbH, 2015, p.14.

has been discussed in the previous chapter, that is, the VAT is a multistage indirect tax generally applied to domestic consumption, its intrinsic advantage is the system of VAT deduction, which is meant to relieve enterprises entirely of the burden of VAT paid in the course of their economic activities. Thus, for such a type of taxation, the principle of neutrality should be the primary guiding principle to obey in the design of its whole system.

4. The current difficulties faced in the Chinese VAT system

4.1 From a general perspective

The problems of course, are not limited to the following two aspects I am going to present, but I think the following two are the most urgent ones requiring resolution.

The first, as I mentioned previously, is the low grade of legislation. The current main legislation on VAT is the Provisional Regulations, which are administrative regulations formulated by the State Council. And the contents of the Regulations are rather simple, for example, the most important one, “Interim Regulation of the People’s Republic of China on Value Added Tax”, has only 27 articles in total, while numerous detailed rules for its implementation are dispersed in the Provisions or Notifications issued by the Ministry of Finance or the State Administration of Taxation. This situation, from one aspect, is not in accordance with the legality of tax³⁰³, from the other aspect, it makes the function of the VAT system in practice rather intricate.

Second, there is the variety of tax rates. The tax rates arrangement in the current VAT system is rather complicated, with five rates for the general VAT taxpayer: 17%, 13%, 11%³⁰⁴, 6%³⁰⁵ and zero rate; three rates for small enterprises or specific areas³⁰⁶: 6%,

³⁰³ Speaking of this, I have to say, we must have a clear recognition of the stage we are in for the current whole taxation system in China. We are still in a period to stress the principle of legal prescription in taxation field, which means, it has not be achieved yet. And this is an objective fact or a basic background, which could not be ignored during the whole VAT reform. The discussion of my thesis should be also based on such a fundamental fact. For this matter, I will give my own view in Chapter 4.

³⁰⁴ The rate of 11% is a newly created tax rate in the ongoing reform, which is only applied to transportation.

³⁰⁵ The rate of 6% here is also a newly created tax rate in the ongoing reform, which is only applied to part of the modern service industry.

4%, 3%. Some of the rates have been added in the reform, as previously stated, and this transitional arrangement has resulted in new problems for the VAT system. However, this is a situation that could not be changed immediately, in fact, in the European VAT system, during its process of integration, the unification of VAT rates among the Member States is also an intractable problem. And even today, no satisfactory solution has been found. The reasons behind the difficulty might be very different for China and Europe, for the latter, one typical obstacle is state sovereignty of the Member States. China, although it has no worry about the matter of state sovereignty, has its own conundrums—how to expand the scope of VAT without aggravating the tax burden for the involved taxpayer³⁰⁷, and in addition, along with the sectors newly included in the scope of VAT, the appropriate tax rate arrangement should be re-investigated. Therefore, to change the situation of the rather complicated tax rate arrangement totally demands the investigation of the practical data from the reform.

4.2 Specific problems for VAT deduction

In addition to the universal problems, such as the interruption of the deduction chain of some special mechanisms, here I present two specific problems in the Chinese VAT deduction system.

First, the deduction of input VAT depends too much on the formal requirement—a VAT invoice. For the consideration of the limited number of professional practitioners and the heavy workload of the tax audit, the formal basis for the deductible chain in VAT—VAT invoice—, is the main element or in other words, a decisive factor in the exercise of the right of deduction, which provides much space for tax fraud. Speaking of this, to combat the tax fraud related to the VAT invoice, a crime of “falsely making out special invoices for value-added tax” is regulated in Chinese Criminal Law, and

³⁰⁶ Prior to reform, the small enterprises applied 6% or 4% according to the different areas. While, in the reform, the previously rates were united by 3%, and the 6% and 4% are applied to the general VAT tax payer in the specific areas which they choose to apply a simple collection method.

³⁰⁷ To reduce the tax burden of taxpayers, especially taxpayers in the field of services is a main object for the new circle of tax reform, and at the same time, reduction of tax burden is good for the reform per se.

the gravest punishment for the crime could be sentenced to fixed-term imprisonment of not less than 10 years or life imprisonment.

No immediate refund is permitted in case of excess input tax for a certain tax period. The excess input tax can only be carried forward to the subsequent tax periods with no possibility of refund, even under the extreme condition of the termination of a company. This treatment is for the convenience of the tax authority and the interest of the state, while to some extent, it is unfair for the tax payer, especially for some special sectors, the extra amount of input VAT might be a significant share of the enterprise's cash flow.

Chapter 4 Future direction for Chinese VAT and its deduction— from the perspective of Europe

Based on the discussion in the previous chapters, a brief conclusion could be drawn: notwithstanding the fact that European VAT is facing a series of problems per se, most of which are related to the right of deduction as well, China could still learn lessons from it, either by making reference to its advantages or avoiding errors through understanding its drawbacks.

Due to the different economic and political backgrounds, especially the entirely disparate nature of the two subjects, some detailed mechanisms adopted or under discussion in Europe may not be suitable for China³⁰⁸, while the situation might be different with regard to the fundamental principles of European VAT, under the premise that both China and Europe run the same type of VAT—credit invoice VAT. Therefore, this chapter is going to analyze the future direction of Chinese VAT and its rules for deduction based on the above described European VAT system, with the focus on the fundamental principles obeyed by the latter. In this direction, the chapter is organized as follows. First it sets out with the basic issue—the legal character of VAT in China, which is discussed in chapter 1 for VAT in Europe. To what extent Chinese VAT and European VAT share the similar legal characters shall be determined on the basis of the analysis of European VAT. Having solved the primary problem—the legal characters that ought to be possessed by Chinese VAT, a short overview of Chinese VAT’s scope both in the past and in the future after the reform, and an analysis of the VAT treatment of certain specific sectors, including immovable property, and the financial and insurance sectors in Europe, will be unfolded, according to which, personal recommendations for the VAT system arrangements of

³⁰⁸ For example, VAT harmonization for intra-community transactions, it is not suitable for China—a uniform country rather than a supranational institution founded on the rule of law that recognizes fundamental rights as the European Union. However, for some special items, the harmonization among the Member States could be helpful inspiration for Chinese VAT reform, as the object of harmonization is to make VAT to fulfill the requirements of the single market in Europe, which is more or less the same with the single domestic market being served by Chinese VAT.

the relative sectors for the ongoing VAT reform in China will be given³⁰⁹. Having decided the deserved role of VAT in China by the above-mentioned two issues, the further discussion or thoughts about the guiding principle being first considered and the interest being first protected in the improvements of Chinese VAT regime and especially its deduction mechanism will be tested and scrutinized in the second part.

Section I The deserved role of VAT in China

A primary question is how to endow VAT with a proper role in China. To this object, the following two issues, as far as I am concerned, are the principal ones: the legal character and the scope of Chinese VAT.

1. The legal characters that ought to be possessed by Chinese VAT

To determine the legal characters that ought to be possessed by Chinese VAT, a brief overview of the characteristics of European VAT can serve as a benchmark. As the basic descriptions have already been displayed in Chapter 1 Section II subsection 2.1, a further analysis of the characteristics of VAT in Europe will be given below.

1.1 Further analysis of the characteristics of VAT in Europe

As stated in chapter 1, VAT in Europe (both on a supranational and national level) is a multistage indirect tax generally applied to domestic consumption. To be such an indirect tax, VAT in Europe has the following characteristics simultaneously, which is explicitly required or implicitly confirmed by the ECJ as well:

First, fiscal neutrality is both the core principle and one of the objects for VAT in Europe, which is reflected in a series of official documents³¹⁰. With regard to the

³⁰⁹ According to the timetable of the reform, 2015 is its ending year, the rest sectors remaining to be improved are the most difficult and thorny ones, among which, the mentioned immovable property, financial and insurance sectors are almost worldwide controversial in VAT system. Europe has made great efforts in these sectors, all of which, either the failed attempts or methods under discussion, can provide beneficial inspirations for China.

³¹⁰ From the First and Second Directive, to the Sixth Directive and finally VAT Directive in 2006, fiscal neutrality is mentioned repeatedly either explicitly or implicitly in the provisions. In fact, the initial motive for the adoption of VAT in EU was that it could relieve the taxable person from the tax burden, in other words, VAT makes the taxable person (the supply and the demand side) make their economic decisions free of the effect of taxation. While, what exactly should the principle of neutrality in VAT mean is quite questionable among the scholars and I believe, it should be changeable along with the development of society.

principle of neutrality, many annotations could be given in the sphere of VAT, not restricted to the deliberation in Chapter 3, and different comprehensions could be generated by standing on the ground of different subjects in VAT tax relationships. Due to the mechanism of input VAT deduction, unlike other types of taxation, the relationship of VAT is triangular, with one additional part—final consumers—as well as the taxable person and tax authority. Therefore, the principle of neutrality may be given different implications from the perspective of different subjects.

For the taxable person regulated in law, additional to the mentioned meaning—a full relief of the VAT burden payable or paid in the course of taxable economic activities³¹¹, fiscal neutrality is provided with a corollary of the equality principle³¹² by the ECJ, as it has repeatedly held that, in the field of VAT, the principle of neutrality is the reflection of equal treatment³¹³, though this view is questioned and not accepted by many scholars. To reason from this logic, fiscal neutrality precludes treating similar economic transactions differently³¹⁴ in the VAT regime. For me, the former aspect of the understanding of the principle of neutrality is more reasonable and sufficient as well for the current VAT in Europe, and it is also consistent with the conception of VAT as a tax on consumer expenditure.

From the perspective of final consumers, those who actually bear VAT burden³¹⁵, the principle of neutrality requires that the taxation on the products should not affect the

³¹¹ This is conceived by the ECJ by settled cases, such as, C-400/98, *Finanzamt Goslar v. Brigitte Breitsohl* [2000] ECR I-4321, para. 37; C-460/07, *Sandra Puffer v Unabhängiger Finanzsenat, Außenstelle Linz* [2009] ECR I-3251, para. 47.

³¹² Equality principle has been considered a fundamental right and thus is one of the fundamental principles of Union law by the settled case law. The substantial requirement of the principle is, according to the Court of Justice, that similar situations not be treated differently justified.

³¹³ This view was confirmed by the Court of Justice in a couple of settled cases, see, joined Cases C-443/04 and C-444/04, *H. A. Solleveld (C-443/04) and J. E. van den Hout-van Eijnsbergen (C-444/04) v Staatssecretaris van Financiën* [2006] ECR I-03617, para. 35.

³¹⁴ The ‘similar’ here refers to the similar goods or similar services which are in competition with each other.

³¹⁵ This is because VAT is set on the basis of a presumption—that VAT burden is shifted forward onto the final consumers. Against to this legal fiction, both doubts and plausibility exist among the scholars, as VAT is a taxation deeply related and influenced by the economic market (the supply and demand in the market). For a deeper understanding, see Clément Carbonnier, “Who Pays Sales Taxes? Evidences from French VAT Reforms, 1987-1999”, *Public Economics*, 2007. 91, pp. 1219-1229. The point of this paper is to provide visual evidence of tax shifting and to measure empirically the distribution of the sales tax burden between consumers and producers.

consumption choice. To attain this target, the mentioned annotation to the fiscal neutrality above for the taxable person—a corollary of the equality principle—, might be more suitable. Which means that for similar goods or services supplied the same amount of tax should be paid. Arguments remain among scholars whether it should be restricted to this criteria. Some argue that the principle of neutrality for the final consumer in the VAT regime should obey the notion of tax fairness as well, which means an equal amount of expenditure must also be taxed equally, without the restriction of the “similar” request. Conversely, for other ones (quite a few), this principle might be associated with the ability-to-pay principle, and the tax amount should differ among the consumers according to their respective ability to pay. However, the latter argument need not be discussed in the present context, as the VAT under discussion does not take the form of a personal expenditure tax³¹⁶.

The second characteristic of VAT in Europe, which was previously mentioned as its first character, is that it is a tax on consumer expenditure. This character was fixed at the beginning of its adoption, and serves as a foundation for the other characteristics and therefore, it is an essential feature to determine the overall arrangement of the VAT system. However, the concept of “consumer expenditure” is not as explicit as it seems, at least, it is not that clear, or is subject to quite a lot disputes in certain sectors, such as financial and insurance services. Notwithstanding the consensus that “consumer expenditure” is the opposite of “business expenses”, and thus lays the foundation for the principle of neutrality, that the taxable person should be relieved from the VAT burden which is charged on the taxable economic activities. Disputes exist in the thorny sectors, and the VAT treatment of the financial and insurance services will be discussed in the next section, which is a typical reflection of the flaw in the understanding or interpretation of the second characteristic whose core vocabulary is “consumer expenditure”.

The last characteristic or feature of VAT in Europe that must be mentioned is that,

³¹⁶ This is also related to the argument whether VAT is a regressive tax and should it be adjusted in VAT system per se or through other systems, such as the other tax type or the national well-being. No further discussion is supposed to be given in this context.

although it is an indirect tax charged almost on all economic activities (both transactions of goods and services), special treatment³¹⁷ is given to quite a number sectors. Deviating from the general working method of input VAT deduction to make VAT a neutral indirect tax, the existence of the exemption mechanism in certain sectors has generated a series of disputes both for the taxable person and tax authorities, which turns into a main source of cases referred to the ECJ. In fact, the application of exemption is almost worldwide in the countries or districts where VAT is adopted as a turnover tax. The situation in Europe might be more typical, as for the nations adopting VAT in recent years, the exemption is restricted as strictly as possible³¹⁸; and with over 20 different VAT regimes in the Member States, the harmonization of the scope of exemption is hard or even impossible to actually achieved and the interpretation of VAT Directive makes the situation more complex. Europe is on its way to further harmonization and perfection of its VAT, and whether the features described above are preserved or abandoned is determined by a couple of factors.

1.2 The legal character of VAT in China—from the past to the future

As described in Chapter 2, VAT in China does not have a long history since its first adoption, and has been quite changeable due to the relatively frequent tax reforms. In the beginning, VAT was adopted due to its theoretical advantage of economic neutrality and what was most important was its proven ability to raise significant revenues³¹⁹. However, being trapped by the limited administrative sources and the immature tax system, VAT in China was far from VAT in the European

³¹⁷ The ‘special’ here refers to the mechanisms operating in a different way from the normal functioning method of VAT, especially with regard to the input VAT deduction mechanism. The most prominent one is the large scale adoption of the exemption.

³¹⁸ For example, in New Zealand, the so called modern VAT which appeared in 1984, has a single rate and very limited exemptions. For further information of the GST(Goods and Services Tax) in New Zealand, see James, Simon and Alley: “Successful tax reform: the experience of value added tax in the United Kingdom and goods and services tax in New Zealand”, *Journal of Finance and Management in Public Services*, 2008, 8, 1: pp. 35-47. This paper describes the nature and brief history of VAT and GST and then assesses the factors that contributed to their success.

³¹⁹ VAT was adopted in China in the 1980–90s, when China launched the wave of economic reform—from the Planned Economy to the Socialist Market Economy. Its advantages to relief business from tax burden and to raise tax revenue made it as the best choice. And from the perspective of outside, it is the worldwide choice then.

sense—covering a relatively comprehensive scope of both goods and services and providing a sound input tax credit deduct system. The VAT system in China possesses the following two fatal flaws.

First, VAT in China occupies a very limited scope—it is only applied to goods, except the limited processing, repair and replacement services. The latest VAT system established prior to the ongoing reform, had very limited scope for about 20 years³²⁰. The limited coverage of VAT not only resulted in poor functioning of the VAT system per se, but also caused serious competitive distortions within the whole market. Many sectors were not covered, in particular of the service sectors, which were taxed by BT, whose tax liability is calculated by turnover, and the business is the actual bearer of the tax burden from the legal perspective.³²¹ The hazards and consequences of this design were described in Chapter 2, which serves as a motive for the ongoing reform as well. However, the reform to expand the scope of VAT is only a reaction on the surface, it is far from satisfying the need for a definitive settlement of the drawbacks resulting. The pure expansion of the scope of VAT cannot directly lead to the fiscal neutrality and the relief of tax burden from business. The soul of VAT which could make the above objectives come true is the input tax credit deduction system. And this is exactly the next point to be discussed—the second flawed characteristic of VAT in China.

Compared with Europe, VAT in China has a rather inadequate input tax credit deduction system. One typical reflection is the treatment of the excess part of the deductible input VAT—no refund is offered, the only choice is to defer it to the next year. This arrangement is totally beneficial for the state, as it hugely reduces the workload of the tax administration; and also no further cash flow occurs once the VAT is received into the treasury. In other words, in respect of VAT, there are only inflows,

³²⁰ The recent VAT system prior to the ongoing reform was established in 1994, by the promulgation and implementation of ‘The Provisional Regulations of the People’s Republic of China on Value-Added Tax’.

³²¹ The actual taker of the tax burden is determined by a couple of factors, especially the economic concern. The legal view of the matter is based on certain assumptions, just like VAT, the characterization as a neutral indirect tax is based on the presumption that the tax burden is forward shifted, and eventually being taken by the final consumer.

no outflows for the treasury. The obvious inclination of the interest of the state cannot match the modern economy,³²² in addition, it is not necessary against the fiscal advantages³²³ of VAT. It seriously erodes the interest of businesses, the most important subject of the market economy. This situation is partly due to the limitation of the capacity of tax administration,³²⁴ but the factor that performs more important role is the ideology formed from the long history (no further remark will be made on this aspect). The ongoing reform has no relationship with the improvement of this aspect, still, I think, this is the further step that should be taken after the reform of expanding the scope of VAT.

The other typical reflection of the inadequate input tax credit deduction system in China is the non-deductibility of the input VAT imposed on the capital goods—a product-type VAT. This means that all the materials consumed in the production process are not deductible for the business, including raw materials, machinery and equipment, immovable properties, etc. Though VAT reform in 2009 entitled the business to deduct the input tax on newly purchased equipment, aiming to transfer the product-type VAT into consumption-type VAT, the related input VAT charged on the immovable properties is still out of the scope of the input credit system. In fact, the deduction of the productive expenses of the immovable properties faces difficulties in Europe as well, such as the adjustment of the deductible amount and the countermeasures to the conversion of use of immovable properties—from business expenses to private expenses, the settlement of the above problems demands a large input of personnel from the tax administration, which, in current China, is no doubt a huge challenge that could not be fixed in a short time. However, the non-deductibility of the input VAT charged from the beginning is obviously harmful to business development, especially in the context of such a high degree of internationalization.

³²² There are deep historical reasons for the emphasis of the interest of the state, both from the culture and economy perspective. But to keep up with the reform pace, this inclination needs to be corrected.

³²³ The specific advantages have been described in Chapter 3 to explain the reasons for the widespread of VAT in the world, and its fiscal advantages, such as its rather extensive scope coverage, its relative independence of recessionary or expansionary fluctuations.

³²⁴ The capacity of administration can always serve as the reason for hysteresis if those in power refuse to make a change, however, it can also play the role as the direction to be improved if the ruler has a positive attitude to promote the reform.

With these two manifest characteristics, VAT in China is facing an urgent need for change. Reforms have been carried out in recent years, but confined to both policy and technical reasons, no substantial change has been actually brought to the Chinese VAT. The ongoing reform, which directly targets the first feature is, without a doubt, a positive signal that sweeping change for VAT in China is coming. Therefore, for the future of VAT in China, the legal characters it should possess are just contrary to the features described above which are those of the past VAT, and still present in part in the current VAT in China—a completely consumption type VAT (with a sound input VAT deduction system) which covers the whole production and distribution chain (a proper scope to make it to be a real neutral indirect tax).

2. The scope of VAT in China—VAT treatment of the remaining tough sectors

As stated in Chapter 2, the scope of VAT in China was rather narrow in the beginning and it was from this point that the discussed VAT reform, which aims to improve the Chinese VAT regime through the extension of the scope of VAT, started out. The scope, however, could be given various annotations from different aspects. From the horizontal perspective, the ‘scope’ is interpreted as the scale of the industries covered by VAT; from the vertical perspective, it refers to the stages involved³²⁵. Since most of the existing VAT systems in the world, including those in Europe and China, have an extensive vertical coverage (from manufacturing to retail), this section unfolds the discussion around the first aspect—from the horizontal view.

As repeatedly mentioned in the foregoing, to be consistent with the principle of neutrality, two premises are required, one of which is the largest possible scope of VAT. Thus the extension of the scope of VAT is essential for the qualitative change of Chinese VAT as well. However, the reform which was expected to be completed in 2015 has run into a bottleneck stage. The difficulties are manifold, from macroscopic, the ongoing reform causes a widespread tax burden reduce, and further generated an

³²⁵ According to the extent of vertical coverage, VAT can be classified as single-stage VAT (the tax is charged on the manufacturing section only), dual-stage VAT (the tax extends from manufacturing through the last wholesale transaction), all-stage VAT (the vertical coverage extends from manufacturing to the retail).

excessive pressure on the national financial³²⁶; from the microscopic view, the remaining sectors—construction, real estate, financial services and consumer services³²⁷—demonstrate a series of difficulties, some of which, also remain unsolved or difficult to handle for the exist VAT regimes in the world, and the most typical ones are financial and insurance services.

2.1 Specific challenges faced in VAT reform of financial and insurance services

The difficulties of the taxation of financial and insurance services exist worldwide, even for states that have already encompassed them within the scope of VAT. For most VAT regimes, financial and insurance services are treated with special mechanisms. In Europe, most of these services are exempt from VAT. For China, facing an opportunity to reorganize the system completely, the choice that should be made depends upon how will the difficulties lie on the road be solved.

The first problem is that the basic theoretical analysis is not very clear in China. With a late start in the 1980s, VAT in China has rather insubstantial theoretical foundations, most of which were introduced from VAT regimes existing at that time, among which Europe is, with no doubt, on the list. The situation at present is that, along with the development of the economy, the Chinese domestic environment demonstrates its own features, which unique so that no single existing VAT regime could fit China well. In addition, the complex of financial services in itself makes the situation more difficult. The financial industry contains multiple sectors such as banking, insurance, securities, funds, etc., and each sector constitutes many complex businesses. The scholars in China are attempting to study this area from both directions: making reference to the other VAT regimes in the world and the research of the specific characteristics of Chinese domestic market. And I hope this thesis will make a contribution to this study. In fact, the deep theoretical analysis of the VAT system of Europe, where it first began, and the various practices around the world could still

³²⁶ According to the State Administration of Taxation, the tax reduction generated from the said reform in 2014 was up to 191.8 billion yuan.

³²⁷ Consumer services is opposite to the producer services, including catering, accommodation industry, household management services, washing and dyeing industry, maintenance services and renewable resources, recycling industry and other services.

serve as beneficial reference materials for China. Among these, the section above discussing the legal characters that should be possessed by Chinese VAT and the following second section about the guiding principle to be obeyed, are fundamental to determine the basic outline of a VAT system which once settled could not be easily changed. And they are also the parts could make reference to the other VAT regimes. However, this is a prudent and meticulous process, not to say the huge amount of work to be done on the analysis of the different existing VAT regimes, and the profound study of the domestic environment is rather significant as well.

Second, from the perspective of a VAT system's construction per se, how to determine the scope and the amount of input VAT deduction is a difficult problem. For this aspect, based on international experiences from the different types of VAT systems—either the traditional European model or the modern New Zealand model—each one has its own drawbacks that need to be overcome. In the context of Europe, the majority of financial services are exempt from VAT, this design is under review in recent years and alternatives are under discussion; some Member States also make their own attempts under the premise of what is permissible within the EU VAT system³²⁸. All these are meaningful for the ongoing reform in China, which for the first time is making efforts to include financial services within the scope of VAT. At the time of writing, the concrete reform scheme for this sector has not yet been released. According to the academic commentators, exemption of the financial services is not likely to be adopted, the detailed treatment will be divided into two categories. For the services for which the added value could be directly calculated, such as safe-deposit boxes, financial assurance and investment advisory services, the general charge method will be applied; for the sectors related to asset allocation, such as credit loans, a simplified charging method will be applied, by which the tax will be assessed on the turnover amount by a relative reduced rate, and the right to deduct input VAT is excluded. Viewing this possible scheme, for most of the sectors that fall into the latter category, no substantial change would result in comparison with the

³²⁸ Detailed introduction is given in the next section—the efforts made and alternatives discussed in Europe with regard to VAT treatment of financial and insurance services.

previous situation of liability to BT. However, with regard to the former category, it is remarkable progress. Considering that the marketization reform of the financial industry has not been completely achieved and its relatively large share of the tax revenue, the favored reform plan in discussion is acceptable. But the pursuit and analysis of a more profound change should not be stalled.

Third, but not the least, is the problem of the capacity of the tax administration. For quite a long period, the financial industry has been charged with BT with no specific invoice system. The relatively specific VAT invoice system exists within its own scope, but the extension of the system to new sectors, just like any new thing, faces unexpected difficulties, to say the least, for a sector that is a challenge for VAT regimes worldwide. The fact that the second problem demonstrated above is not fully resolved makes the situation more intractable. Still further, to encompass the financial services into the scope of VAT is not only a challenge for the tax administration, but also a puzzle for the related businesses. The establishment of the independent accounting books, the new calculation of the tax liability, and the complex deduction system, all these elements are troublesome areas for the mature VAT systems which have run in this sector for years, not to mention a system that is still in the process of being established.

To sum up, to include the financial services into the scope of VAT is an inevitable step for the improvement of the VAT system in China,³²⁹ but in light of the difficulties that lie in both the VAT system and the attributes of special industries, the step could not be made too far, but with certain small paces. As a result, the reform program for the financial services will outline a transitional VAT system for this sector and more profound change will demand further theoretical analysis and the observation of the implementation of the “temporary” program.

³²⁹ The international experience suggests that VAT is an ideal indirect tax that can guarantee both the fiscal neutrality and the tax revenue alike, to ensure the neutrality to the level as high as possible, the maximum scope of VAT and its deduct mechanism is the only path to follow.

2.2 The efforts made and alternatives discussed in Europe with regard to VAT treatment of financial and insurance services

The EU VAT system, which is mainly regulated by VAT Directive 2006, treats most financial services as exempt from VAT³³⁰, within the exemption list provided in Articles 132–136 therein. The exempted transactions listed are subdivided into two categories: exemptions in the public interest³³¹ and others. The financial services under discussion are in the second camp (mainly regulated in Article 135 of the EU VAT Directive 2006), because of the objective technical difficulties in the calculation of the tax base and its deductible input VAT.

However, as time has passed, the landscape of financial services has changed a lot³³² and the so-called technical difficulties do not remain as difficult as they were. On the contrary, over the course of time, the rules related to exemptions being implemented in 27 Member States have proved to be a failure, with little of the positive effects they were supposed to have, but rather huge problems. These are associated with the distortion of competition and VAT planning activities, which make it a significant source for legal dispute³³³. Therefore, discussions have taken place regarding alternative methods for taxation of the financial sector.

The latest official attempt made to tax financial services was in the Proposal³³⁴ for the reform of the treatment of insurance and financial services. In this Proposal, an amendment to the provisions of the VAT Directive was suggested to contain an option

³³⁰ The harmonization of the scope of exemption of VAT substantially regulated first in the Sixth VAT Directive, including rules on a limited number of uniform and compulsory tax exemptions. Prior to this, the first two VAT Directives involved very few about the exemption mechanism in the harmonization of VAT, Member States were almost entirely free to regulate exemptions in their national VAT systems.

³³¹ The exempted items in this category are normally called merit goods or services, such as health or education related activities, the rationale for exempting these goods or services is either to diminish the regressivity of VAT, or to encourage their consumption.

³³² The appearance of new economic patterns and the consequences of the financial crisis have had a huge impact on the function of such a industry.

³³³ The problem is universal for the whole exemption mechanism in VAT, thus the questions arise—whether exemptions are really a necessary evil or rather unnecessary, or they are no evil at all? For further information of this aspect, see Rita de la Feria, *VAT Exemptions. Consequences and Design Alternatives*, Kluwer Law International, 2013, pp. 37-100, Chapter 2 “The EU Perspective on VAT Exemptions”.

³³⁴ The Proposal, which was presented on November 28, 2007, consists of two documents: a proposal for a Council Directive (COM [2007] 747) and a proposal for a Council Regulation (COM [2007] 746).

allowing financial institutions to tax the financial services they provide to their customers, that is Article 1(4) of the proposal for a Council Directive, in which a new Article 137(a) was introduced in VAT Directive 2006 to provide the option to tax.

This is not the only attempt or method that has been tried or mentioned either in the official documents or in discussion among scholars. Some were put into practice in a few Member States or regions, some were abandoned before being implemented. Whereas, any of them might be significant for the Chinese VAT reform, irrespective of whether it was adopted by the legislator or not. The following is a brief conclusion on the attempts made or possible alternative methods discussed from two directions, in order to have an overall understanding and provide a solid foundation for the discussion of the next section—the inspiration for the ongoing VAT reform in China.

First, there are alternative new taxes for certain sectors in the financial industry, especially for the sectors in which it is difficult to calculate the added value, such as banking and insurance. The new taxes being introduced include but are not limited to the following two types: specific financial transaction taxes (FTT) or financial stability contributions (FSC)³³⁵. The rationale of this method is to charge another type of tax on the sectors where it is most difficult to impose VAT, while the non-deductible nature of the input VAT charged to these sectors and the incompleteness of the deduction chain—which is crucial for the neutrality of VAT—, remains in the system. The adoption of new taxes could solve the problem of the loss of tax revenue and combat the tax fraud related to these sectors to some extent.

Second, attempts are made within the boundary of VAT to overcome the technical difficulty in calculating the added value. The efforts made in this direction started with the approval of the Sixth VAT Directive in 1977, in which the financial services were exempt from VAT. The exemption in this sector created difficulties and economic inefficiencies for both traders and tax administrations. For the former, the irrecoverable input VAT resulted from the exemption and the vague definition of the

³³⁵ As far as I know, FTT has already been introduced in quite a few Member States in Europe, such as Belgium, Greece, Finland, Ireland, the United Kingdom and Switzerland.

scope of exemption generated both extra product cost and compliance cost, and further created the resort to VAT planning and aggressive planning. For the latter, the “definitive” loss of revenue³³⁶ and significant administrative costs are the main defects caused by the exemption of financial services. In addition, it also gives rise to the internal distortion of the VAT system, which will eventually affect the function of the market which VAT serves. Therefore, remedies for this mechanism are sought and discussed by both scholars and legislators. One remarkable attempt was noticed in the late 1980s—applying the cash flow method³³⁷ to realize the full VAT taxation on financial services. This approach was widely debated in academia. Based on the discussion, the European Commission set out to conduct a review of the EU VAT treatment of insurance and financial services in the mid 1990s, which gave birth to an advanced cash flow method for charging VAT in the TCA Report in 2000³³⁸. Though the improved cash flow method made the full taxation of financial services successful, it was not accepted eventually by either legislators and businesses, for both theoretical—departure from the credit invoice VAT system—, and practical reasons it was too complex to apply it.

Attempts in both of these two directions are unable to be promoted, especially for the second one. However, as far as I am concerned, the reasons for the objections to applying the TCA method are quite questionable and not convincing, in particular against to current background. But considering the complexity of the constitution of the VAT system in Europe and the strong policy influence from the Member States,

³³⁶ The ‘definitive’ here is relative, as against to the background of market economy, the extent of the loss depends on several factors. From the external perspective, the extent will vary, on one hand, according to the economic relevance of the exempt sector involved, on the other hand, whether alternative taxes are charged; and from the internal perspective, the national approach to the right to deduct input VAT will be of particular relevance. For further information, see Rita de la Feria, “The EU VAT Treatment of Insurance and Financial Services (again) under Review”, *EC Tax Review* 2007, 16 (2): 74–89.

³³⁷ See L. A. Hoffman, S. N. Plddar and J. Whalley, “Taxation of Banking Services under a Consumption Type, Destination Basis VAT”, *National Tax Journal* 1987, 40: 546-554. The debate around it was that the method constituted a clear departure from the transaction-by-transaction basis VAT.

³³⁸ TCA, known as the truncated cash flow method, is an alteration to the original cash flow approach. By TCA, distinguish was made between B2B transactions and B2C transactions by respectively applying zero rating of VAT and standard rate of VAT. For further information of the working path of TCA, see Commission of the European Communities, *The TCA System—A Detailed Description* (2000).

the slow promotion of the taxation on financial services is understandable. And it is not fruitless after all, despite the lack of a full consensus; the prevailing view is that full taxation constitutes the ideal treatment from a tax policy perspective³³⁹.

2.3 Inspiration for the ongoing VAT reform in China

The core for the determination of the direction to be taken for Chinese VAT reform in the remaining tough sectors is, first, what is the initial intention or the ultimate objective of the reform; second, consideration and deep understanding of the realistic conditions and circumstances in China which form restrictions and boundaries for VAT reform in China; and last but not the least important, it is the guiding principle and interest protection chosen by the future VAT in China. For the second one, as stated above, the special national conditions—both from the respective development level of certain sectors and the limited administrative capacity, predestine the ongoing reform to expand the scope of VAT which is just a new start for VAT and even further for the whole tax system in China. The step being taken will not send VAT to an ideal status that it deem to be, even it is theoretically clear what is the right design for a perfect VAT. The restriction or discrepancy between the reality and the ideal can never be eliminated by any VAT system, but it might be much more notable for current China³⁴⁰. And regarding the third point, further discussion will be displayed in the second section. Therefore, my attention will be focused on the first aspect—the initial intention and the ultimate objective of the ongoing VAT reform in China.

In Europe, there has been a debate on whether it is an inevitable to charge the financial services and the other sectors with VAT as a general consumption taxation, since there are so many difficulties to applying the general method to these sectors and some special mechanisms have to be designed for them. These special mechanisms, in return, have generated new problems, which is far from the benefit

³³⁹ See Howard H. Zee, “VAT Treatment of Financial Services: A Primer on Conceptual Issues and Country Practices”, *Intertax* 2006, 34: 10, pp. 458-474, at pp.460.

³⁴⁰ The compromise made to the reality in China is greater than the other States or districts in the world, at least for the current stage. This might be related to a social issue—the gap between the economic development and the development of the other aspects, which I am not going to discuss further here.

VAT is supposed to have³⁴¹. The fatal weakness of these mechanisms is the denial of the right to deduct, which undermines the integrity of the deduction chain and destroys the pursued neutrality. Take the exemption, for example, compared with the supposed alternative choice— another type of taxation would cause the loss of tax revenue, in addition to the identical effect of breaking up the deduction chain. Returning to China, the intention to start the VAT reform is to expand the scope of VAT to the previously excluded sectors in order to complete the deduction chain and therefore achieve fiscal neutrality; and relieve business from the tax burden in order to promote its development. Starting from this point, the integrity of the deduction chain must be the first element to be considered in the reform process of any decision made. More specifically, the application of the exemption must be restricted to the narrowest scope and the situation is the same with the unique method to be adopted in China—the simplified VAT charge method³⁴², since the latter has the same effect as the former—to break up the deduction chain by excluding the taxable person’s right to deduct. While due to the completed process of the reform, the latter method was applied widely because of its similarity with the work method of the BT, which was previous imposed on these (newly included) sectors. As aforementioned, the situation is understandable and tolerable as a temporary transitional method, but this is a central part that needs to be further handled and improved in the future, otherwise, just like the transitional period in Europe, the temporary method could result in much trouble which might be more serious than the situation before the reform.

For the financial services in discussion, the attempts made in Europe can serve as an important inspiration for the ongoing VAT reform in China. The prevailing view of the debate on the VAT treatment of financial services in Europe, that full taxation constitutes the ideal treatment from a tax policy perspective, gives us another

³⁴¹ Exemption is one of the special mechanisms which results in the mentioned problems. The substantial of the problem is, the design of the mechanism exclude the right to deduct from the taxable person, which breaks the ‘heart’ of VAT—deduction chain, and let VAT be worthless for these special sectors.

³⁴² This method, which has been introduced in Chapter 2, charges VAT on the taxable person of special feature (such as the small scale business) or in certain sectors with a reduced rate on their turnover, and precludes their right to deduct.

direction of thinking. And the further exploration of the alternative methods for the exemption of financial services provides some more concrete trains of thought.

SectionII Guiding principle and interest protection in Chinese VAT

Based on the elaboration above, VAT in China suffers quite a number of disadvantages in the design of its specific mechanisms. Some of these are puzzles faced by most of the VAT systems in the world, and the countermeasures are in discussion in the other VAT systems, such as, the exemption of financial services in Europe. Some of them, however, are unique to the VAT system in China, such as the limited scope of VAT and the inadequate input VAT deduction system. To address these drawbacks, it is not possible to make reference directly to the existing VAT systems in other parts of the world, as special national conditions can never be ignored. Whilst, different to the detailed design of mechanisms which might be only adapted to their original environments, the fundamental principles to be based on and the interest of the part³⁴³ which they are more inclined to protect are two general aspects that VAT systems could directly learn from each other. Therefore, in this section, I would focus on these two aspects (mainly based on research on VAT in Europe), to give suggestions for the future direction of VAT in China.

1. The guiding principle to be obeyed for China's VAT reform

The principle of neutrality has been elaborated at length in the previous chapters, and this principle is also one of the basic principles to be concerned in the establishment of VAT in China. However, its concrete implementation in China is unsatisfactory, due to several factors: the history restriction, political influences, etc. In my view, the most significant element is its interpretations which deviate from its proper meaning. Thus, in this section, the improper interpretations of the principle of neutrality in China and the reasons behind them will be analyzed first, then the interpretations and their evolution in Europe of this principle will be discussed in brief. Finally the proper interpretation of the principle of neutrality in the current VAT system in China is

³⁴³ As stated in Chapter 3, the relationship of VAT is triangular, the tax authority, the taxable person ruled by law and the final consumer who actually takes the tax burden. The legislators shall make their preference due to the objective circumstances and the legal charter of VAT itself during the legislative process. However, in practice, it is more complicated, influence might come from period's political requirements and the restrictions from the other aspects as well (economy is one typical element, for example).

discussed based on the previous contents.

1.1 The improper interpretation of the principle of neutrality in China

The principle of neutrality is a basic principle in tax policy, in other words, it is a fundamental principle to obey for all types of taxation. To be consistent with this principle, a tax should be neutral and equitable between forms of business activity. From the perspective of the economy, a neutral tax will contribute to efficiency by ensuring that optimal allocation of the means of production is achieved. And in addition, a neutral tax should raise revenue while having no (or minimal) influence on any single economic choice³⁴⁴. In principle, it is a widely accepted concept in the tax policy, while in practice, within different tax systems, and for different taxation types, the concept and its implications could be difficult to be suitable for the particular goal of a specific tax³⁴⁵. This situation is particularly prominent in the VAT regime, as the principle of neutrality is not only a basic principle to obey in its system design, but is also a natural result of a well functioning VAT system. And for such an indirect tax, neutrality is given particular interpretations within its field. However, the case in China is not as such as it ought to be.

1.1.1 The general interpretation of neutrality principle in China's tax system

From a historical perspective, the principle of neutrality was introduced into China in the late twentieth century, but just on the theoretical level. The debate about whether the principle of neutrality can be applied in China's tax system has never come to a conclusion. The objectors mainly hold the view that this principle is not in line with China's market status. They argue that the principle of neutrality can only play its role in a well-developed market economy, where either the regulation of the economy or the allocation of resources is not mainly through taxation, so that reducing the impact of tax on the market will promote market development. This is not the situation in

³⁴⁴ In this sense, a distortion, and the corresponding dead-weight loss, will occur when changes in price trigger different changes in supply and demand than would occur in the absence of tax. As such, the goal is to raise revenue without distorting the decisions that individuals and firms would otherwise make for purely economic reasons.

³⁴⁵ The tax treatment of health-care is the most economically important way that the tax code departs from neutrality. The tax code also departs from neutrality to discourage specific activities, like smoking and alcohol consumption.

China, however, where the development time of the market economy is so short that it needs appropriate intervention from the government to ensure the rational allocation of resources and regulate the operation of the economy. Based on all the above, the conclusion is that the implementation of tax neutrality is not beneficial in China's current market economy.

Despite the opposing views above, the principle of neutrality still attracts quite a lot attention from most scholars and exerts more or less influence on the tax legislation, and new interpretations are given in the context of the special national conditions in China.

The objection to the adoption of the principle of neutrality in China's tax policy is, to some extent, the result of misunderstanding or at least an insufficiently profound understanding of the principle. The main function of tax initially is a tool to raise fiscal revenue in order to support the expenditure of the government, therefore a neutral tax should not impose any influence to the economic decisions made by the subjects in a market, no external effects (either positive or negative) should result from the tax liability, except for the tax being paid.³⁴⁶ To achieve this target, the requirement that taxpayers in similar situations and carrying out similar transactions should be subject to similar levels of taxation should be satisfied in the first place³⁴⁷. This is indeed the basic meaning contained by the principle of neutrality in the tax field from the beginning. With the newly added functions of the tax—not only a simple tool to raise revenue, but also an important macro-control instrument of the government³⁴⁸—the meaning of the principle of neutrality is more various and flexible. Its position as well as its meaning in the tax policy varies a lot due to the legal character of every single tax type. In practice, trade offs between different concepts of

³⁴⁶ It essentially means that the tax system should not distort choices and behavior of the subjects in the market.

³⁴⁷ This is quite similar to the principle of equality.

³⁴⁸ This change happened in the late 1930s and early 1970s, when the tax policy was influenced by the macroeconomic theory put forward by Keynes. At that time, the interpretation of the principle of neutrality is quite different from its initial meaning—no impact is posed to the subjects' behavior in the market, it is interpreted as the adverse effect of tax to the market should be reduced to the smallest possible extent. However by the late 1970s, the principle of neutrality came to a time of back to its initial meaning and achieved a further development.

neutrality and different goals can be difficult to resolve. However, the total ignorance of this principle in the tax policy-making process is unacceptable, as in several cases this concept can provide a useful way to cut through some of the debates about tax policy and identify a more economically efficient way to organize the tax system.

From the description above, the interpretation of the principle of neutrality mainly differs due to the preferred role given to the tax—more inclined to its fiscal function³⁴⁹ or its political role in the economy³⁵⁰. Obviously, under the current tax system in China, regarding the role of tax, more emphasis is put on the latter, whilst the understanding of the principle of neutrality is restricted to the former, both of which jointly result in the conclusion that the principle of neutrality is not suitable or applicable in current China. I am quite opposed to this viewpoint; it is acceptable that the role of tax in policy should be emphasized, but not understandable of the conclusion made from it, as the principle of neutrality can play its role under such a precondition as well. In fact, the ideal or pure neutral tax system does not exist anywhere in the world;³⁵¹ in some cases, neutrality might be impossible³⁵² and, in other cases, it might not be desired by the policymakers³⁵³. The “compromise” made by the principle of neutrality is another exemplification of its implementation, and research in the ways that the tax system approximates or departs from principle of neutrality can be a helpful lens for viewing a range of tax policy and economic problems.

Notwithstanding the fact that the principle of neutrality is not universally acceptable in China’s current tax system, the neutral feature of VAT was noticed at the beginning of its adoption in China.

³⁴⁹ Its role as a tool to raise fiscal revenue.

³⁵⁰ Its role as an instrument of macro-control of the economy.

³⁵¹ As a matter of fact: “There is no such thing as a truly ‘neutral’ tax system”, Alex Easson, “Fiscal Discrimination: New Perspectives on Article 95 of the EEC Treaty”, *Common Market Law Review*, 1981, 18, pp. 521-551.

³⁵² Precisely speaking, the neutrality in the strict sense cannot be obtained in every single case, and policymakers have to accept a certain level of distortion to behavior as inevitable.

³⁵³ This happens when policymakers intend to promote specific goals like the provision of health insurance or contributions to charity.

1.1.2 The position of the neutrality principle in the Chinese VAT system

The neutral characteristic of VAT came into the view of legislators since its adoption, in fact, the rapid spread of VAT and its popularity in the world is mainly credited to its neutrality, which enables it to raise revenue in an imperceptible way and has no extra impact on the manufacturers or distributors in the production and distribution chain. But just as already expressed, in China neutrality was only noticed as a basic feature of VAT, but not as its basic principle, which needs to be complied with and to be implemented. The misconception from the beginning has played a great role (but of course, not in all) in the design of its subsequent concrete mechanisms, such as the system of deduction of input VAT.

The ongoing VAT reform is a great opportunity to review the neutrality feature of VAT and which can in turn help to promote the reform in the right direction. In my view, the first and most important aspect is to change our understanding of “neutrality” in VAT—not just as a natural result of the adoption of VAT, but as a basic principle which is essential to establish a neutral VAT. In order to realize this shifting on the conscious level, it is important first to have a clear understanding of the specific meaning of the principle of neutrality in VAT, and then the additional meaning (if it had any) it should take under the special national condition in China.

The former aspect—specific meanings of the principle of neutrality in VAT—has been restated in the previous sections,³⁵⁴ therefore the focus here is fixed on the second aspect—under the special national condition in China, should the principle bear additional meanings? And if so, what contents should it contain? The VAT system in China, which was established prior to the reform and based on the previous understanding of the neutrality in VAT as a natural result of VAT, suffers serious drawbacks, violation of the neutrality being one of the most typical ones, which includes, the erosion of competition neutrality resulted from its limited scope, the

³⁵⁴ The neutrality in VAT can be understood on two different levels: internal and external. For the former, it compasses three forms: legal neutrality, competition neutrality and economic neutrality; for the latter, it mainly related to its international aspects, to make sure of equal treatment between the products of domestic and from outside.

sacrifice of economic neutrality resulted from the incomplete deduction chain, etc. However, all the problems are in the camp of the already existing meaning of the principle of neutrality, thus, there is no need to give additional meaning to the principle of neutrality under China's current VAT system. Whereas, extra emphasis should be put on a certain meaning, that is the economic neutrality, which is not in line with the measures purposely taken by the legislator for political or other reasons. And this is exactly the weak point of the whole tax system in China, being taken shape by both historical and cultural influences. To overcome it, attempts have been made from various aspects, including promoting the concept of the rule of law, and the concrete measures that should be taken in the VAT field is the simplification and certainty of the tax rates³⁵⁵. It is frustrating that the ongoing VAT reform applies quite a complex tax rate design, but as aforementioned that is acceptable as a transitional and temporary measure. Closely following the VAT and BT reform, is VAT legislation, and one of its targets is to simplify the tax rate—to combine the current 17%, 13%, 11%, 6% and other levels of tax rates into two or three levels, and appropriately reduce the base rate. With regard to the certainty of the tax rate—not frequently changed as a measure to achieve certain political objects—, the newly amended “Legislation Law” in China provides a powerful support, in that it provides that “the establishment of any category of tax, determination of tax rates, tax collection administration, and other basic taxation rules” can only be governed by laws³⁵⁶.

In all, the state in which neutrality is viewed as a bounded consequence of the adoption of VAT should be changed. And the economic aspect of the principle of neutrality needs extra attention in its implementation under the special national conditions in China. It is heartening that attempts have been made on different levels.

³⁵⁵ VAT is considered as a regressive turnover tax, and introduction of differentiating rates is used to diminish its regressive effects, by which, reduced rates are applied to the necessities of life and, higher rates are applied on luxury products. However, surveys suggest that a minimal effect has been achieved, by the contrary, economic neutrality is serious influenced.

³⁵⁶ This is newly added contents in Article 8 of Legislation Law of the People's Republic of China (2015 Amendment). To put essential tax factor into the framework of the law can help to restrict government from arbitrarily introducing tax policy, thereby enhancing the certainty of the tax law.

1.2 Interpretations of the principle of neutrality in Europe

Quite different from the situation in China, the principle of neutrality has attracted quite a lot attention and been repeatedly stressed in Europe, since it came into being as a fundamental principle to promote the establishment of an internal market in Europe. Proceeding from this point, the interpretation of this principle in Europe has its own focus, and particular stress was put on both the competition neutrality and external neutrality. Because of its specific significance for the establishment of the internal market in Europe, there was debate on whether it was a rule of primary law³⁵⁷ in Europe, or only a principle to be obeyed in the interpretation of VAT Directives. Conclusion was given by the recent case law of the ECJ in the VAT field, that the principle of neutrality is not a rule of primary law which can condition the validity of a provision of a European Directive; it is only a principle of interpretation, to be applied concurrently with the principle of strict interpretation of VAT exemptions. Notwithstanding, it still plays a unique and irreplaceable role in the VAT system of Europe.

1.2.1 The principle of neutrality versus the principle of equality

The principle of neutrality, or rather fiscal neutrality, lays down in Article 2 of the First VAT Directive (now Article 1(2) of VAT Directive 2006):

The principle of the common system of VAT entails the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services, however many transactions take place in the production and distribution process before the stage at which the tax is charged.

On each transaction, VAT, calculated on the price of the goods or services at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of VAT borne directly by the various cost components.

Cases presented to the ECJ and relevant questions therein referred for a preliminary ruling basically focus on the proper interpretation of the principle of neutrality expressed in the above articles. The contents of the mentioned articles implies a

³⁵⁷ Primary law, also known as the primary or original source of law, can be seen as the supreme source of law in the European Union (EU). It is at the apex of the European legal order. It consists mainly of the founding treaties of the European Union. Because of its legal status as the supreme source of law, it can condition the validity of a provision of a European Directive.

general principle—the principle of equal treatment. The general principle of equal treatment requires that comparable situations must not be treated differently and different situations must not be treated in the same way unless such treatment is objectively justified. The prohibition of discrimination can be its specific expression, to which, Article 18 TFEU (ex Article 12 TEC)³⁵⁸ gives the support to make it primary EU law and having constitutional status. And this is where the disputes arise between taxpayers and tax authorities—whether a specific VAT treatment is inconsistent with the principle of neutrality, which is viewed by the taxpayer to be the same as the principle of equal treatment—a general principle, and has its effect as primary EU law.

The relationship between the principle of fiscal neutrality in VAT and the principle of equal treatment should be clear first, and the legal status of the former is as follows. With years of implementation and according to the case-law of the ECJ, it is clear and affirmative that, regarding the first question, the principle of fiscal neutrality was intended by the Community legislature to reflect, in matters relating to VAT, the general principle of equal treatment³⁵⁹. However, regarding the legal status of the principle of fiscal neutrality, it does not enjoy the effect of primary EU law as a principle of equal treatment, since it requires legislation to be drafted and enacted, in other words, it requires a measure of secondary EU law³⁶⁰. Which implies that the

³⁵⁸ In which, it provides: “Within the scope of application of the Treaties, and without prejudice to any special provisions contained therein, any discrimination on grounds of nationality shall be prohibited. The European Parliament and the Council, acting in accordance with the ordinary legislative procedure, may adopt rules designed to prohibit such discrimination.”

³⁵⁹ ECJ, 29 October 2009, Case C-174/08, *NCC Construction Danmark A/S v. Skatteministeriet* [2009], ECR I-10567, in paragraph 41, see also, to that effect, Case C-309/06, *Marks & Spencer* [2008] ECR I-2283, paragraph 49. The principle of fiscal neutrality shot center stage upon the delivery of the judgment in Rank (joined cases C-259/10 and C-260/10), ECJ, 10 November 2011, *Commissioners for Her Majesty's Revenue and Customs v. The Rank Group plc.* [2011] ECR I-10947. On 13 March 2014, the ECJ delivered five VAT judgments—*Finanzamt Saarlouis v. Heinz Malburg* (C-204/13); *FIRIN* (C-107/13); *Jetair* (C-599/12); *ATP Pension Service A/S* (C-464/12); and *Klinikum Dortmund* (C-366/12)—all of which considered the impact of fiscal neutrality. The judgments are difficult to reconcile and it would appear that the principle of fiscal neutrality is, in some cases, pulling the law in different directions.

³⁶⁰ There are three sources of EU law: primary law, secondary law and supplementary law. The main sources of primary law are the Treaties establishing the European Union. Secondary sources are legal instruments based on the Treaties and include unilateral secondary law and conventions and agreements. Supplementary sources are elements of law not provided for by the Treaties. This category includes Court of Justice case-law, international law and general principles of law. For further information, see

principle of fiscal neutrality is not an independent general principle of EU law, and therefore, its implementation and relevant interpretations in the VAT field should be tested in the context of the VAT regime.

1.2.2 Principle of neutrality's role in European VAT

The significance and importance of fiscal neutrality is explicit in the following paragraphs of the Preamble of VAT Directive 2006:

(4) The attainment of the objective of establishing an internal market presupposes the application in Member States of legislation on turnover taxes that does not distort conditions of competition or hinder the free movement of goods and services. It is therefore necessary to achieve such harmonization of legislation on turnover taxes by means of a system of value added tax (VAT), such as will eliminate, as far as possible, factors which may distort conditions of competition, whether at national or Community level.

(6) It is necessary to proceed by stages, since the harmonization of turnover taxes leads in Member States to alterations in tax structure and appreciable consequences in the budgetary, economic and social fields.

(7) The common system of VAT should, even if rates and exemptions are not fully harmonized, result in neutrality in competition, such that within the territory of each Member State similar goods and services bear the same tax burden, whatever the length of the production and distribution chain.

Resulting from the requirements of establishing an internal market and to ensure its good functioning, the principle of neutrality in VAT mainly exerts its influence from two aspects. One is the stress on competition neutrality, which means that the tax should impact in the same way on anyone carrying on the same or similar economic activity, otherwise, the tax would distort competition and further harm the proper function of the internal market in which the goods and services move freely. This aspect is the one mentioned above—the principle of fiscal neutrality was intended by the Community legislature to reflect, in matters relating to VAT, the general principle of equal treatment. Fiscal neutrality of VAT in this aspect means a lot on the Community level, normally a national law proposing a difference between two

Terra and Kajus, *A Guide to the European VAT Directives*, Chapter 1, “Sources of EU Tax Law”.

competing operations will be ruled against by the ECJ³⁶¹.

However, as a neutral indirect tax, fiscal neutrality in VAT is used in a different sense, which is enshrined by the deduction mechanism, that is to relieve the trader entirely of the burden of VAT payable or paid in the course of all his economic activities³⁶². Fiscal neutrality in VAT in this sense causes the other two problems in practice, as an exhaustive neutrality cannot be achieved in any VAT system. One is the non-deductible treatments provided by the Directive itself—for example, the provisions of exempt items—which will violate the neutrality in both aspects, it does not only break the deduction chain but also generates different treatments when other similar supplies are not exempt. And this is one of the main origins for the cases brought to the ECJ asking for a preliminary ruling. The ECJ normally responds by interpreting the relative provision narrowly, that is, where there is an exception to the general rules of VAT, the law will be followed strictly and the exception will only be applied if the situation clearly falls within it³⁶³. And the other problem in practice is the negative effect of its implementation, the fulfilling of the principle of neutrality in VAT in EU should avoid its abusive use, thus the prevention of the abuse of rights (especially, the right to deduct) shall be borne in mind, in other words, VAT and the principle of neutrality therein cannot be used as a means of regulating the lawfulness of trade.

In a VAT system, the principle of fiscal neutrality is always connected with the right to deduct besides the emphasis on no distortion of competition described above. The great importance of the right to deduct has been consistently stated in the previous

³⁶¹ For example, Member States may make a particular tax exemption dependent on the legality of the transaction under other domestic rules – the ECJ has on numerous occasions ruled that this is unacceptable.

³⁶² Fiscal neutrality of VAT in this sense is reflected in Article 168 of VAT Directive 2006, in which the scope of input deduction is ruled, and it is also confirmed by the Court who has held that the common system of VAT seeks to ensure neutrality of taxation of all economic activities, provided that those activities are themselves subject in principle to VAT, see Case C-174/08, *NCC Construction Danmark A/S v. Skatteministeriet* [2009], ECR I-10567, paragraph 27, and Case C-277/09, *The Commissioners for Her Majesty's Revenue & Customs v. RBS Deutschland Holdings GmbH* [2010], ECR I-13805, paragraph 38.

³⁶³ This is not taken so far that the exception is deprived of its effect, but transactions cannot be exempt simply because they are similar to other transactions which qualify.

chapters, and it is also repeatedly upheld by the ECJ, which has stated that the right of a trader to deduct input tax is so fundamental to the principle of fiscal neutrality that “in principle [it] may not be limited”³⁶⁴. Owing to this fundamental right, quite a number of VAT taxpayers structure their business affairs or transactions to be conducted in a VAT-efficient manner, which results in the increasingly aggressive nature of VAT planning arrangements in practice, and pushes the tax authorities to the application of an abuse of rights doctrine. One example is the UK tax authority making reference to the ECJ case-law in which the ECJ recognizes the existence of abuse of rights as a principle of EU law,³⁶⁵ in its domestic cases, such as those involving the Halifax Bank, the University of Huddersfield³⁶⁶ and the health care insurer BUPA,³⁶⁷ to deny the trader’s right of deduction because of the existence of an abuse of rights. The issue whether the principle of abuse of rights can or should be applied to VAT is beyond the scope of this discussion. The principle to be mentioned here is intended to illustrate that the principle of neutrality in VAT is so fundamental that it should not be infringed arbitrarily, but it does not mean this principle grants a taxable person any right to deduct input VAT where the transactions from which that right derives constitute an abusive practice.

To make a brief conclusion, the principle of neutrality plays a fundamental and unique role in European VAT due to its advantages of no distortion of competition and support for the right of deduction. It is viewed as a primary principle to be obeyed in

³⁶⁴ See Case C-409/99, ECJ, 8 January 2002, *Metropol Treuhand WirtschaftsstreuhandgmbH v. Finanzlandesdirektion für Steiermark and Michael Stadler v. Finanzlandesdirektion für Vorarlberg* [2002], ECR I-00081, paragraph 42.

³⁶⁵ See Case C-110/99, ECJ, 14 December 2000, *Emsland-Stärke GmbH v Hauptzollamt Hamburg-Jonas* [2000], ECR I-11569, in which, the Court endorses the doctrine of abuse of rights as having the status of a ‘free-standing and independent principle’ of EC law.

³⁶⁶ Halifax (Case C-255/02), a banking establishment, and the University of Huddersfield (Case C-223/03), a university, wished to carry out construction works. Since most of their services were exempt from VAT, they would have been able to recover only a small proportion of VAT. However, both Halifax and the University of Huddersfield prepared schemes enabling them, through a series of transactions involving different companies or organizations, to recover in practice all the input VAT paid in respect of the construction works.

³⁶⁷ In the BUPA case (Case C-419/02), a United Kingdom company which manages a large number of private hospitals concluded contracts with other companies in the same group for the future supply of drugs and prostheses. In order to benefit from a much more favorable VAT system, they arranged for the payments under those contracts to be made before delivery of the goods and before the entry into force of legislation amending that system.

the establishment and concrete design of a VAT system in Europe, but not a principle of primary EU level, therefore the right to deduct which is in accordance with the principle will not necessarily be afforded under certain situations³⁶⁸. Compared with the case in China, differences can be found in the following three aspects, all of which are the points deserving special attention in China's ongoing VAT reform: first, there is the position of the principle in the VAT system. China has not yet viewed it as a fundamental principle which needs to be obeyed and ensured by the specific mechanisms therein, but rather a natural result of VAT. This is the origin for the drawbacks existing in China's VAT system. Second, different aspects of the principle should be stressed due to the respective special conditions in Europe and China—competition neutrality in Europe for the good functioning of an internal market, and economic neutrality in China because of its special historical powerful political interference. Last, it is the different level of development of the principle of neutrality in Europe and China, which is derived from the first aspect. For Europe, it is in a stage of restriction and balance with the other principles in order not to be abused, while in China, it still needs to be recognized and establish its position as a fundamental principle in VAT.

2. Choice of interest protection to be made by VAT in China

As the American jurist Oliver Wendell Holmes, Jr. said: “Taxes are the price we pay for civilization”. Tax has served as a fundamental instrument of generating fiscal revenue since its first appearance in the history of human society³⁶⁹. Whereas the theoretical foundation of charging taxation has experienced different stages, and one of the most important turning points is the awareness of the right of taxpayer and its protection. The recognition of taxpayers' rights was generated from the knowledge of the nature of taxation. Being considered as a restriction to one of the fundamental

³⁶⁸ One of the situations is the above described—when an abuse of rights is found to exist.

³⁶⁹ Taxation has just as long a history as the policy, however, the word ‘tax’ first appeared in the English language only in the fourteenth century. It derives from the Latin ‘taxare’ which means ‘to assess’. The principal function of taxation is to act as a compulsory contribution being imposed by a government on its citizens for meeting all or part of its expenditures. But along with the development of civilization, taxation plays a role more than a revenue raiser, its effective function for political purpose has been examined as well, such as to redistribute wealth.

rights of the individual—the property right,³⁷⁰ taxation bears the expectation of its payer to obtain benefits being provided by the state which was supported by it alike. Therefore, taxation, to some extent, could be seen as a barometer of the developing balance between the interest of the state and the interests of taxpayers, and VAT, a general indirect tax on consumption is certainly not an exception. Unfortunately, the concept of taxpayers' rights was first raised as an instrument supporting voluntary compliance of taxpayers, or at least this is a preferred motive, which, seen from the balance, is quite biased to the interest of State. However, with the expansion of the service-oriented culture from private enterprise to the public administration, commentators and scholars have made efforts to explore a larger framework for taxpayers' rights which is beyond a basis for improved compliance. However, owing to the different levels of development between states, the level of protection of taxpayers' rights differs as well among the nations. In this section, the general conditions for protection of taxpayers' rights in China will be displayed in the first section, and section 2 presents the protection of taxpayer's rights in China's VAT regime. Last, suggestions are made, on basis of the inspiration from the European experience and exploration, for the protection of taxpayers' rights in China's VAT system.

2.1 General conditions for protection of taxpayers' rights in China

Protection of taxpayers' rights was not proposed or the subject of much attention until recent years in China. This disregard has complicated grounds. As far as I am concerned, the following two aspects are responsible for the neglect: first, the poor awareness of taxpayers' rights; second, the limited guarantees and scarce legislation for protection of taxpayers' rights in China.

³⁷⁰ The recognition of the nature of taxation has different theoretical bases, basically flowing from two fundamental conceptions of property rights—consequentialist and deontological theories: briefly, in the latter theory, taxation is seen as a necessary limitation on individual freedom; whereas, in the former one's, taxation is viewed as a means of distributing important social goods and that it shall therefore have a much wider role. The detailed discussion of the above concepts is not involved in this thesis, for further information, see L. Murphy and T. Nagel, *The Myth of Ownership: Taxes and Justice*, OUP, 2002.

2.1.1 Poor awareness of protection of taxpayers' rights

The unconsciousness of protection of taxpayers' rights is variously manifested, and to consider it from the basic relationship in the taxation, both tax authorities and taxpayers lack of recognition of this regard. This disappointing situation is deeply embedded in China's long cultural history—being affected by the feudal culture for more than 2000 years, and not going through the enlightenment of modern democratic ideology, both of which result in the absence of civic consciousness³⁷¹. The further consequence is the emphasis on power while ignoring rights. In the taxation field, there is the serious inclination towards the interest of the state in its balance with the interest of taxpayers.

However, the good news is that protection of taxpayers' rights is coming into the field of vision of the Chinese academic circles quite recently, and this plays great role in promoting its development on both the conscious level and the practical level. This magnificent progress cannot be separated from the context of international concerns on this subject and the growing interaction with global businesses of the Chinese government³⁷². The awakening of the consciousness of taxpayers' rights can definitely help its concrete implementation on both the legislative and administrative levels, but it takes time, and, to be honest, the realistic protection of taxpayers' rights being provided by the existing legislation is not cause for optimism.

2.1.2 The existing legislation for protection of taxpayers' rights

Compared to the late awakening of consciousness of protection of taxpayers' rights in China, the specific implementation of it in practice has rather fallen behind. Such backwardness is embodied particularly in the following aspects: first, it is the incompleteness and poor organization of the rights being regulated. The protection of

³⁷¹ In addition to the influence of the feudal culture, another important factor that could not be ignored here is the infiltration of Marxist theories in modern China, or rather more, it is the cornerstone of China's socialism. And one basic feature of the theories is, little recognition of individual property rights, to proceed from this point, taxation is primarily concerned with funding the State and redistributing social goods.

³⁷² China's accession to WTO in 2001 was a remarkable one that promoted the realization of the taxpayers' right and to take it serious in the perfection progress of China's tax law system, in which, the non-discrimination requirement in the GATT (General Agreement on Tariffs and Trade) has played great role.

taxpayers' rights in China is added and only partly confirmed quite recently by the procedural taxation law—the Law of the People's Republic of China on the Administration of Tax Collection,³⁷³ Article 8 therein regulates:

Taxpayers and withholding agents shall have the right to inquire of the tax authorities about the tax laws and administrative regulations of the State as well as the information related to tax payment procedures.

Taxpayers and withholding agents shall have the right to require the tax authorities to maintain confidentiality for the information of the taxpayers and withholding agents. The tax authorities shall maintain confidentiality for the information of the taxpayers and withholding agents in accordance with the law.

Taxpayers shall, in accordance with the law, have the rights to apply for the reduction, exemption and refund of tax.

Taxpayers and withholding agents shall have the right to statement and the right of defense to the decisions made by tax authorities; and shall have the rights to apply for administrative reconsideration, institute administrative litigation, ask for State compensation, etc. in accordance with the law.

Taxpayers and withholding agents shall have the right to bring charges against or make exposure of any tax authority or tax official for violation of laws or disciplines.

The taxpayers' rights in the article above give a primary and basic impression that although the Tax Administration Law provides the basic framework for protection of taxpayers' rights, they are, however, relatively messy and incomplete, and most importantly, they are brief and restrict themselves largely to administrative rights in the context of improving voluntary compliance. Nevertheless, compared with the previous situation—with no single word about taxpayers' rights but only their obligations, it is encouraging progress, and what is more inspiring is the promulgation of the Announcement of the State Administration of Taxation on the Rights and Obligations of Taxpayers in 2009, to inform taxpayers of their rights in the process of fulfilling their tax obligations, including the right to know, the right to confidentiality and fourteen other rights, throughout the tax administration procedures from the

³⁷³ Since its first adoption in 1992, Law of the People's Republic of China on the Administration of Tax Collection has been amended three times, respectively, in 1995, 2001 and 2015. The provisions that rule the taxpayers' right protection were added during its second amendment in 2001.

assessment of tax liability to the payment of tax due and the legal remedies. The Announcement focuses on taxpayers' procedural rights, but not substantial rights, and this is the second point of the backwardness I am going to explain—"procedure over substance" or the rights are just displayed with rare substantive guarantee. The reasons are various, the most important one is the late awakening of the personal private property, and much later of its confirmation by law³⁷⁴. A pure list of rights makes no difference without the relevant viable measures for their implementation. Take the right of legal remedies as an example; according to the Announcement, against decisions made by the tax authority, taxpayers are legally entitled to apply for administrative reconsideration, administrative proceedings, and to request state compensation, etc. However, all these rights can only be exercised under such a precondition—the taxpayer must first pay or remit the taxes and the late fee in accordance with the decision on tax payment made by the tax authority, or provide a corresponding guarantee. This precondition is primarily found in the Law of the People's Republic of China on the Administration of Tax Collection³⁷⁵ and is reiterated in the Announcement. Another aspect which is quite unfavorable to the taxpayer is the 'remedy of last resort', the potential applicants (taxpayers) who challenge the decision of the tax authority should apply for an administrative reconsideration before using judicial review. To some extent, this is reasonable with consideration of the efficient allocation and use of judicial resources, and this 'remedy of last resort' approach is only limited to the decision of tax payment, but not the sanction decision or the mandatory measures or measures of taxation by the authority³⁷⁶. While, to provide a substantive guarantee of the taxpayers' rights, both

³⁷⁴ Property Law of the People's Republic of China was not promulgated until in 2007, prior to it, there was no substantive confirmation and protection of the personal private rights on the law level in China.

³⁷⁵ The precondition is regulated in the first paragraph of Article 88 of the Law of the People's Republic of China on the Administration of Tax Collection: "If any tax dispute between the tax authority and a taxpayer, withholding agent or tax payment guarantor occurs, the taxpayer, withholding agent or tax payment guarantor must first pay or remit the taxes and the late fee in accordance with the decision on tax payment made by the tax authority, or provide corresponding guaranty, and then after may, apply for an administrative reconsideration in accordance with the law. If they object to the decision made after the administrative reconsideration, they may bring a suit in the people's court in accordance with the law."

³⁷⁶ Paragraph 2 of Article 88 in the the Law of the People's Republic of China on the Administration of Tax Collection states: "Where a party concerned objects to a sanction decision made by the tax

aspects should be improved in order to make the judicial remedies more accessible to taxpayers.

The last point about the backwardness of the legislation in the protection of taxpayers' rights is that all the above-mentioned legislative and the administrative rights have no root in the Constitution. There is only one tax-related provision in China's Constitution,³⁷⁷ Article 56: "It is the duty of citizens of the People's Republic of China to pay taxes in accordance with the law", belonging to Chapter 2 therein under the title, "The Fundamental Rights and Duties of Citizens". This expresses explicitly that the payment of taxes is the duty of citizens, with no single word of taxpayers' rights. The absence of the provision of taxpayers' rights is, in turn, a manifestation of the poor awareness of taxpayers' rights protection in China resulted from the long term's obligation standard in the taxation field.

Therefore, the current legislation for protection of taxpayers' rights in China is no better than its late conception awareness, or even much worse, since there is a time gap between the awareness and the concrete implementation. And the fact is, with a pure list of the taxpayers' rights on the administrative level, but no confirmation of them in the Constitution, and no relevant substantive guarantee for their implementation, the protection of taxpayers' rights is not more than the paper it is written on.

2.2 Protection of taxpayers' rights in China's VAT—from the perspective of the right to deduct

Taking the function as the core of the VAT system, the right of deduction is the node which can perfectly manifest the implementation of protection of taxpayers' rights in a VAT regime. This is not because I admit the right to deduction is one specific right enjoyed by the taxpayer,³⁷⁸ but its function does, to a great extent, reflect the

authority or to the mandatory measures or measures of taxation by the authority, he may apply for an administrative reconsideration in accordance with the law or bring a suit in the people's court in accordance with the law."

³⁷⁷ Constitution of the People's Republic of China, has gone through 4 times of amendments since its first adoption in 1982, and the latest amendment was made in 2004.

³⁷⁸ As elaborated in Chapter 3, the right of deduction in VAT is not a taxpayers' right in the true sense,

emphasis of the idea of protection of taxpayers' rights, which, in other words, is the equal relationship between the tax authority and the taxpayer, and a balance of justice between the interest of the state and the interest of taxpayer, or even a little inclined to the latter because of the absolute advantage of the former. In my view, the right of deduction in VAT is a necessary part of the tax charge itself, and its exercise, being initiated by the taxpayer, is a cooperation between the tax authority and taxpayer, therefore, to make sure of the efficient exercise of the right to deduct is not a protection of the taxpayers' rights, but a much more basic element in the VAT charge process, whereas the more efficient and convenient way of exercise of the right to deduct, the more vividly of the reflection of the idea of Right Standard.

China is seeking an appropriate balance between revenue raising, fairness and economic-growth enhancing types and levels of taxes. The ongoing reform in VAT is one of the steps therein, and with regard to the right of deduction, the following two aspects are where to be improved in order to cater to the service-oriented government's establishment.

2.2.1 Deductible items

VAT in China has gone through a series of reforms since its adoption in the 1980s, and is still an ongoing reform. One of the most important targets of all the reforms is to transfer it from a productive VAT into a consumptive VAT—to embrace the expense of equipment and other capital investments into the range of deductible items. The range of deductible items in VAT directly affects the pecuniary interest of the VAT taxpayer—to decide whether the already paid input VAT on the expense could be recovered by the means of deduction. Therefore, from the perspective of the taxpayer, the more extensive the range the more favorable the interest of the taxpayer. However, the deductible items in China's VAT were not enlarged to the fixed assets until 2009,³⁷⁹ being part of the ongoing VAT reform. This was in "Notice of the Ministry

but an essential mechanism in the function of a credit invoice type VAT, and it is actually a cooperation provided by the taxpayer.

³⁷⁹ In fact, the reform concerning extending the scope of VAT credit started first in 2004 within several pilots in north-east regions in China, as that part is the traditionally the heavy industrial base of China.

of Finance and the State Administration of Taxation on Several Issues concerning the National Implementation of Value-added Tax Reform”³⁸⁰. Article 1 therein states:

From January 1, 2009, a general taxpayer of VAT (hereinafter referred to as the “taxpayer”) may have the input tax amount which occurred from the purchase³⁸¹ or self-production³⁸² of a fixed asset (hereinafter referred to as the “input tax amount for a fixed asset”) deducted from the output tax amount according to the relevant provisions of the Interim Regulation of the People’s Republic of China on Value Added Tax³⁸³ (hereinafter referred to as the “Regulation”) and the Detailed Rules for the Implementation of the Interim Regulation of the People's Republic of China on Value-added Tax³⁸⁴ (hereinafter referred to as the “Detailed Rules”) and upon the strength of the special VAT invoice, special bill of payment of import VAT obtained from the customs and freight settlement voucher (hereinafter referred to as the “VAT deduction vouchers”), and the input tax amount shall be entered under the item of “Tax Payable—VAT Payable (Input Tax Amount).

Wherein the fixed asset, the carrier of the newly included deductible item—input VAT amount on a fixed asset, refers to the fixed asset being defined in Article 21 of “Detailed Rules”: it refers to machinery, mechanical equipment, means of transport and other equipment, instruments, apparatus, etc. related to production and operation with a service life exceeding 12 months. This means VAT charged on the purchase of goods or services for the transfer of intangible assets or the sale of real estate or a real estate project under construction³⁸⁵ is not deductible. In practice, VAT charged on the mentioned items is a considerably large amount of funds, its non-deductible nature seriously erodes the interests of the taxpayer. In addition, the discrimination between fixed assets and real estate artificially creates difficulties in its implementation, as it is difficult to divide accurately buildings, structures and ground attachments, such as the transmission lines of electric power enterprises, pipelines of water supply enterprises, and storage tanks and pipelines of oil refineries.

³⁸⁰ No. 170 [2008] of the Ministry of Finance.

³⁸¹ Including acceptance of donation and investment in kind.

³⁸² Including rebuilding, expansion of building and installation

³⁸³ Order No. 538 of the State Council.

³⁸⁴ Order No. 50 of the Ministry of Finance and the State Administration of Taxation.

³⁸⁵ According to Article 23 of the “Detailed Rules”, The term “real estate” refers to property which is immovable or the nature or shape of which will be changed after movement, including buildings, structures and other land attachments. And the real estate which is newly built, rebuilt, expanded, repaired or decorated by a taxpayer shall be a real estate project under construction.

With the exclusion of VAT imposed on real estate from the scope of VAT deductible items, China's current VAT is not yet a throughout consumptive type, the non-deductible nature of VAT imposed on the relative items not only results in the break of the deduction chain, which threatens the the principle of neutrality, but also leads to direct infringement on the interest of the taxpayer. Therefore, departure from the protection of taxpayers' rights, to include the above-mentioned items into the deductible scope, is the task to be completed in the next step.

2.2.2 Treatment of the excess of the deductible input VAT

The treatment of the excessive amount of the deductible input VAT was briefly mentioned in sub-section 5 in section II of Chapter 2 as a specific problem for VAT deduction. According to Article 4 of the Regulation, "If the output tax amount for the current period is less than and insufficient to offset against or deduct the input tax amount for the current period, the deficiency can be carried forward to the following period for offset or deduction". But for how many subsequent periods could the deficiency be carried forward and what is the countermeasure on the condition that the company can no longer operate and come to a cancellation? Either of these questions is explicitly regulated. Such an arrangement of the excess of the deductible input VAT erodes the interests of the taxpayer, from at least two aspects, first, lack of an immediate refund directly affects the cash flow of the taxpayer; second, the current arrangement—to carry forward to the following period, leaves a large space of discretion in practice, and the uncertainty or ambiguity further affects the taxpayer's decisions, with a tendency to aggressive tax planning in order to avoid such an uncertain situation.

Actually, in practice, the excessive amount of deductible input VAT can also be used to offset the tax debt of the taxpayer, but only restricted to VAT debt³⁸⁶. Such an arrangement is beneficial to the taxpayer who owes the state a VAT debt. In my opinion, such a benefit should reach more taxpayers by extending the counterpart of

³⁸⁶ This treatment is regulated in the "Notice of the State Administration of Taxation on VAT general taxpayer to offset VAT debts with the excess value-added tax paid", No. 112 [2004] of the State Administration of Taxation.

the excess deductible input VAT from VAT debt to all the types of tax debts.

With regard to the refund of the excess of input VAT, it is not completely impossible in all sectors, a way has been opened for Software and Integrated Circuit Industries in 2011, according to the “Notice of the Ministry of Finance and the State Administration of Taxation on Refunding Un-credited VAT Each Period for Equipment Purchased by IC Enterprises”,³⁸⁷ the un-credited VAT formed by the procurement of equipment by enterprises of major IC projects at the end of each period can be refunded. But in addition to the subjective requirement, two objective conditions must be satisfied: first, the un-credited VAT is formed by the procurement of equipment; second, the purchased equipment shall fall within the scope of fixed assets as provided in the second paragraph of Article 21 under the “Detailed Rules for Implementing the Interim Regulations of the People’s Republic of China on Value-added Tax”.

In conclusion, under the current VAT legislative system, the general treatment of the excess of the deductible input VAT is to carry it forward to the following periods. For the taxpayer who has a VAT debt, an alternative is provided, to offset that amount of debt. And as an exception, an immediate refund is allowed for the IC enterprises with certain conditions to be met. The only exception provided is more like a tax incentive for the purpose of policy. Therefore, in the future design of the treatment of excess deductible input VAT, efforts could be made in the following directions: first, to offset the general tax debts of the VAT taxpayer, but not only restricted to the VAT field, by which both the interests of the state and of taxpayer are taken in consideration, but of course, this arrangement demands a comprehensive tax information system. Second, to expand the immediate refund mechanism to all the taxpayer and the un-credited VAT occurred on all VAT taxable objects. This could not be achieved in one step, as it demands the tax administrative capacity to follow it up. Notwithstanding the

³⁸⁷ No. 107 [2011] of the Ministry of Finance, the notice was released for the purpose of fulfilling the relevant requirements of the "Notice of the State Council on Issuing Several Policies on Further Encouraging the Development of the Software and Integrated Circuit Industries" (Guo Fa [2011] No.4), and solving the problem of funds outstanding for input VAT caused by procurement of equipment by enterprises of major IC projects.

difficulties, to build a right-oriented VAT system and to put more emphasis on the protection of taxpayers' rights should always be the guiding principle in the future construction of China's VAT system and its deduction mechanism.

2.3 Improvements in protection of taxpayers' rights in China's VAT: inspirations from Europe

The current conditions for protection of taxpayers' rights in China's VAT system are relatively weak, both from the general condition in the whole tax system and from the specific condition in China's VAT regime. The history and experience of Europe in the protection of taxpayers' rights could serve as beneficial inspirations for its improvement in China's VAT.

2.3.1 Brief view on the protection of taxpayers' rights in Europe

Compared with China, the protection of taxpayers' rights in Europe has a longer history and a more solid foundation, both at the supranational and domestic level. Especially after the Second World War, significant developments in the protection of taxpayers' rights have been made in the former aspect, a notable one is the European Convention on Human Rights (ECHR).³⁸⁸ Article 1 of its Protocol 1 provides for the property right:

Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law.

The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties.

The peaceful enjoyment of one's possession is one's property right—one of the fundamental human rights. And from the second paragraph quoted, we could infer that the payment of taxes is, essentially, an impairment to the taxpayers' right, but it is

³⁸⁸ The European Convention on Human Rights (ECHR) (formally the Convention for the Protection of Human Rights and Fundamental Freedoms) is an international treaty to protect human rights and fundamental freedoms in Europe. Drafted in 1950 by the then newly formed Council of Europe, the convention entered into force on September 3, 1953.

justified by the public interest. The terms of this article illuminate the relationship between the protection of human rights (mainly the property right) and tax matters, which provides an international basis for the protection of taxpayers' rights. The significant number of tax-relative cases being lodged in the European Court of Human Rights³⁸⁹ is the proof of the influence of human rights on tax matters.

On the domestic level, besides the protection provided in the tax legislation, most of the European states include the protection of taxpayers' rights in their constitutions, which provides the strongest form of primary legal right enforceable by law. Such constitutional rights are usually only indirectly related to taxation, but can underpin the basic framework for the operation of tax administration, collection and enforcement.³⁹⁰ The German Constitution³⁹¹ is typical, in which, numbers of rights are provided to taxpayers, including equality before the law,³⁹² the right of property³⁹³ and right to appeal,³⁹⁴ etc. The relative protection provided in a nation's constitution provides protection to the taxpayers' rights in the substance of the tax law, but not simply in the procedures available within the tax system.

³⁸⁹ The European Court of Human Rights is a supranational or international court established by the European Convention on Human Rights. It hears applications alleging that a contracting state has breached one or more of the human rights provisions concerning civil and political rights set out in the Convention and its protocols.

³⁹⁰ See, Duncan Bentley, *Taxpayers' Rights: Theory, Origin and Implementation*, Kluwer Law International, 2007, p.113.

³⁹¹ It is called 'Basic Law for the Federal Republic of Germany', and was Promulgated by the Parliamentary Council on May 23, 1949.

³⁹² In Article 3: (1) All persons are equal before the law. (2) Men and women have equal rights. (3) No one may be prejudiced or favored because of his sex, his parentage, his race, his language, his homeland and origin, his faith or his religious or political opinions. And the Constitutional Court interpreted it in the context of taxation to mean that those with an equal ability to pay tax should bear the same tax burden.

³⁹³ In Article 14: (1) Property and the rights of inheritance are guaranteed. Their content and limits are determined by the laws. (2) Property imposes duties. Its use should also serve the public weal. (3) Expropriation is permitted only in the public weal. It may take place only by or pursuant to law which provides for kind and extent of the compensation. The compensation shall be determined upon just consideration of the public interest and of the interests of the persons affected. In case of dispute regarding the amount of compensation, recourse may be had to the ordinary courts. The content of this article is much or less the same with Article 1 of protocol 1 in ECHR.

³⁹⁴ In Article 17: Everyone has the right individually or jointly with others to address written requests or complaints to the competent authorities and to the representative assemblies.

2.3.2 General improvements of protection of taxpayers' rights in China's tax system

Taking both of the above two aspects into consideration—general conditions for protection of taxpayers' rights in China and the protection of taxpayers' rights in Europe, two aspects of general improvements can be made, in my view, in China's tax system for the protection of taxpayers' rights.

The first, and also the fundamental one, is to establish and enhance the awareness of rights both from the tax authority and the taxpayers' perspectives. To obtain such a target, it is important for tax authorities to change their train of thought—from power-oriented to right-oriented, and to levy taxation with an attitude of service, in other words, the relationship between the tax authority and the taxpayer should be equal, from the traditional public-law relation to the equal private-law relation. How to view the relationship between the tax authority and the taxpayer is beyond the research scope of this thesis and I will not go into it. The protection of taxpayers' rights needs adjustment to the balance between the interests of the state and of taxpayers, and the comprehension of the relationship between the two aspects play a critical role in it. Another indispensable factor for the improvement of the protection of taxpayers' rights is the consciousness of rights from the aspect of the taxpayer per se. This is particularly important in the context of the long history of feudal culture in China. The establishment of the awareness of rights among the taxpayer or citizens demands, again, the efforts of the state. Therefore, it is the state that plays a key role in the process of establishing the awareness of rights in the tax system.

Second, and a more practical aspect, is to give support to the protection of taxpayers' rights in the Constitution. As described above, the current legislation on the protection of taxpayers' rights in China is lack from the Constitution, which provides the strongest form of primary legal right enforceable by law. To achieve this goal, it is not sufficient just to add a provision or several provisions to the Constitution, but demands the procedural support of constitutional review, which is not possible in present-day China. Thus, it is a huge task to achieve substantive progress in the

process of improving general conditions for the protection of taxpayers' rights, since it requires changes and reforms in various fields, not just the tax regime.

2.3.3 Specific efforts to be made in China's VAT regime

As discussed above, the problems around the protection of taxpayers' rights in China's VAT system mainly rest on the issue of the right of deduction. And the improvements can be made from the two aspects: first, the expansion of the scope of the deductible items, especially the deduction of input VAT on the expenses of the fixed assets and the other capital investments; second, a general and immediate refund of the excessive amount of the deductible input VAT. Both of these have been elaborated in the previous section, and here I would not go into it.

In any case, because of the particularity in the operating mode of VAT, special demands of the tax administrative construction are needed. Thus, whatever the specific efforts are to be made, it is inseparable from the strengthening of the capacity of tax administration.

Finally, to conclude this chapter, to be clear on the future direction for Chinese VAT and its deduction mechanism, it is important, in the first place, to determine what role VAT should play in China, which is mainly shaped by its legal characteristics and its chargeable scope. Only under such a precondition could China's VAT find its due place and play its deserved role. In the second place, it is important to determine the guiding principle and interest protection orientation in the future construction of China's VAT system, since the special features of VAT and the unique relationship between tax authority and taxpayer result from the right of deduction therein. The principle of neutrality should be given a fresh look—not as a natural result of the imposition of VAT, but as a core principle to obey throughout its implementation. In regard to interest protection, the long neglect of taxpayers' rights should be highlighted. To this object, attempts should be devoted to the improvements of both general conditions in the whole tax system and special conditions in the VAT regime. For the former, it is essential, firstly, to establish the awareness of rights both for the

tax authorities and taxpayers, and second, the legislative protection should be provided on the foundation of constitutional guarantees. For the latter, efforts should be made around the right of deduction—on the one hand, to expand the deductible scope to fixed assets and other capital investments; and on the other hand, to realize an immediate refund of excess input VAT.

Chapter 5 Conclusion—Proposals for Chinese VAT legislation

1. General remarks

Notwithstanding the fact that the ongoing reform, which was supposed to be completed in 2015, is blocked by several formidable obstacles from particular sectors, the legislation of the VAT to set down all the measures into a formal law is, no doubt, the next step of the reform. Assuredly, the legislation of VAT not only aims to fix all the issues of the ongoing reform—which aims to expand the scope of VAT, but also serves as an important step for the implementation of the rule of law in the tax field and to promote the legislation of taxation³⁹⁵. The ongoing reform of VAT is just a small part of the reform of the whole tax system, therefore, as an “achievements exhibition” of VAT reform, the introduction of VAT law shall be carried out in a thoughtful and comprehensive manner—not only to perfect the VAT system itself, but also to make it compatible with the other relevant tax laws, especially the tax administration law. To that end, efforts shall be made from both sides. Thus, the contents of this chapter are organized as: first to make suggestions specific to the VAT system—from the overall/general to the specific, then to point out the improvements to be made in the tax procedural law.

2. Suggestions on the overall level

As stated in the previous chapters, the adoption and implementation of VAT in China was carried out in an immature way. The interpretation of the characteristics of this type of tax might have some misunderstanding in the beginning, and coupled with the special requirements of the times (which, for example, resulted in the co-existence of

³⁹⁵ Due to the special historical reasons, most of the substantive tax regulations in China were formulated by the State Council in forms of interim provisions or regulations, but not as formal laws. The so called “authorized legislation” was rooted in a decision of the National People's Congress being issued in 1985—“Decision of the National People's Congress on Authorizing the State Council to Formulate Interim Provisions or Regulations Concerning the Reform of the Economic Structure and the Open Policy”. The full text of this decision can be found in the annex 1 of this chapter. Prior to the Decision in 1985, the first regulation of VAT—“Regulations of the People's Republic of China on Value Added Tax (Draft)” was issued by the State Council in 1984 according to the “Decision of the Standing Committee of NPC Authorizing the State Council to Reform the System of Industrial and Commercial Taxes and Issue Relevant Draft Tax Regulations for Trial Application”. Full text of this decision can be found in Annex 2 of this chapter.

BT), the VAT system was not designed in a proper way, especially for the guiding principle and the orientation of interest protection, both of which form the base of the whole construction of the system.

2.1 Being guided by the principle of neutrality

Like any type of tax regime construction, the establishment of the VAT system shall be guided by certain principles, which reflect the characteristics of the specific type of tax and in turn, help to fulfill its due role with the proper natures.

But also unlike any other taxes, the imposition of VAT, from the ideal angle, does not exert additional economic influence on the business, since it is a tax undertaken by the final customers. This is normally considered as a typical reflection of the principle of neutrality. Unfortunately, the adoption of VAT in China in the beginning, whether on purpose or not, has not fully interpreted such a principle and, in some ways, the neutrality was viewed only as an internal nature of VAT, but not a principle to be complied with and executed throughout the VAT system. In fact, this “ignorance” exactly catered to the economic and administrative conditions at the time in China. The emphasis on efficiency, rather than neutrality, in building the tax system promoted Chinese economic development. However, this is no longer the situation at present either from the external (international) or internal (domestic) aspect. From the former aspect, the frequent participation and interaction of the transnational economic activities demands a more neutral VAT system to ensure a fair competitive environment. And from the latter aspect, a more neutral VAT regime is essential to the economic restructuring, as the vertical integration can be interrupted to a large extent with a complete deduction chain.

Thus, the ongoing VAT reform, to expand its scope to the areas subject to BT, is a juncture to review its basic principle in the rebuilding of this system. And the ignored principle of neutrality, shall be given its due role—to perform as a guiding principle in building the VAT system, to guide the following steps of VAT legislation. To such an object, the first thing is to figure out the proper meaning of this principle, and the

second is to implement it through the detailed design of the specific mechanisms therein. The one that cannot be overlooked is the deduction system, which is discussed in detail in the following section.

With regard to the proper meaning, a profound and detailed discussion has already been presented in Chapter 2, but how the proper meaning could be fixed into Chinese special conditions is the issue to be discussed here. First, to rectify the former misunderstanding of neutrality in VAT, rather than as a natural result or effect, it is a principle which can only realize its value through the function of specific mechanisms. Misunderstanding and misinterpretation is the root of the ignorance of the principle of neutrality. And even when it is viewed as a basic principle, the understanding of it is restricted to the neutral feature of tax on the whole, which requires the imposition of a tax that poses minimum affect on the economic decisions. Apparently, the important and crucial role of the principle of neutrality has not been realized in China. Second, based on the current economic development status in China and the historical construction of circulation tax system on goods and services, besides ensuring the equality aspect of the neutrality principle, certain transitional measures shall be adopted in the newly included industries, which might require tolerance of the non-neutrality in transitional period in some specific fields.

In all, the rebuilding of the VAT system in China definitely should be guided by the principle of neutrality, and the most important is to establish the correct recognition of such a principle, and then it is how to implement its proper meaning through the specific mechanisms under the special conditions in China.

2.2 Emphasis on protection of taxpayers' rights

Whatever the tax type, the balance between the assurance of the tax revenue of the state and the protection of taxpayers' rights cannot be avoided. This is decided by the tax feature since its birth, and become highlighted by the coming of the modern civilization. In the process of liability to VAT, as mentioned above, the taxpayer actually exists in two different types—the person ruled in the law, and the person who

finally bear the tax due, and the protection of taxpayers' rights in question is related to the former. Obviously, the emphasis of protection is proposed from a relative angle, and its importance and significance become outstanding in current China due to Chinese history in which, the absolute power of public authorities had overwhelming superiority over the private rights for quite a long time.

The recognition and vocalization of protection of taxpayers' rights has never been made in science in academia, while government agencies have paid it some attention in recent years. Wide discussion and studies have been carried out on the definition and contents of taxpayers' rights, and a basic expression on these issues has been given in Chapter 4, here I would like to make a conclusion on a general level. First, the protection of taxpayers' rights raised here is with respect to the power of tax authority and still further, it is the interest of state. The legal relationship between the tax authority and the taxpayer generated by the tax charging is like a balance of the public interest and the sacrifice of the individual interest³⁹⁶. With two separate items in the balance, to add weight on one part means relatively less weight on the other part. Therefore, the protection of taxpayers' rights could be achieved from the other side, that is to restrict the power of the tax authority, or in other words, some concessions might be made from the interest of the state. To such an end, the restriction shall be implemented in the specific mechanisms design, especially the core mechanism—the system of deduction of input VAT. This will be further discussed in the subsequent section. Second, the protection can be achieved in a more straightforward way—to highlight the right status of the taxpayers. For this reason, the explicit statement of a particular right is needed. Efforts have been made in general, such as the Taxpayer Bill of Rights in different countries, and the “Taxpayers' Rights and Obligations—Practice Note” released by the OECD. However, all the

³⁹⁶ There are various theories about the generation and function of the ‘tax’, and along with the development of the social patterns, the theories evolved themselves. A typical one is the Debtor-creditor theory, by which, the relationship between the tax authority and taxpayer is viewed as a relatively equal one, similar with the debtor-creditor relationship in private law. And the tax due paid is, more or less, like the price for the public services provided by the national governments. However, irrespective of the detailed theories which form the basis for taxpayers' rights protection, the root is the same—the acknowledgment of the individual property right. And this is exactly where, the Chinese government does not handle well.

documents just list the rights, and most are procedure related³⁹⁷. When it comes to the protection in a specific tax type, there is still a long way to go. And in the VAT system, the establishment of the right to deduct and how to protect it is one of the focal points in its building. Which again, is closely linked to the deduction system therein.

3. Core mechanism design—the input VAT deduction system

Either the guiding principle or the interest protection orientation can only provide the basic direction to the final object, but not the actual path. The building of the path needs the detailed design of mechanisms, and the crucial one is the input VAT deduction system. This section aims to make a conclusion of the previous discussion about the deduction system, to provide suggestions and inspiration for Chinese VAT legislation based on the international experience.

3.1 Establishment of the right of deduction

In the process of charging VAT, the way in which the input VAT can be deducted is rather important to the interest of the taxpayer. On the other side, it is also the weakest point in the system which can be easily taken advantage of by the taxpayer to conduct tax evasion or tax fraud. Therefore, the function of the deduction system in VAT shall keep both sides in mind—to combat the tax fraud or tax evasion and to ensure the interest of the law-abiding taxpayer. The establishment of the right to deduct is in the front line of such a balance. This section starts out by the analysis of the nature of the right to deduct, and then makes a further discussion of the time point and the requirements to be satisfied for its establishment.

3.1.1 The nature of VAT deduction

Despite the fact that the key of such a core mechanism in VAT regime is called the ‘right’ to deduction or ‘right’ of deduction, no documents or legislation explicitly defines it as a ‘right’ which is enjoyed by taxpayers, and not to mention whether it is

³⁹⁷ For example, the Taxpayer Bill of Right in the US, including the following rights: the right to be informed, the right to quality service, the right to pay no more than the correct amount of tax, the right to challenge the IRS’s position and be heard, the right to appeal an IRS decision in an independent forum, the right to finality, the right to privacy, the right to confidentiality, the right to retain representation and the right to a fair and just tax system.

authorized/entitled to or inherently retained by the taxpayers.

In fact, the discussions and arguments about the nature of the input VAT deduction are widespread in both Europe and China. Especially in China, along with the recognition of the protection of taxpayers' rights, calls to fix the input VAT deduction as a right enjoyed by VAT taxpayers have been getting stronger³⁹⁸. And some of them have made reference to the European VAT system to support their argument. I completely understand their boon original intention, however, I do not agree with their argument and its line of reasoning. Whether the deduction of input VAT is a right or not is been expounded in Chapter 2 of this thesis, in which I denied its feature as a 'right' by proving that the deduction of input VAT cannot satisfy the basic legal requirements of a 'right'. In light of the reference made by the supporters, the exact word "right" is adopted in many official documents and legislation in European countries. I personally hold that this is just a matter of language expression, but does not name it from a precise legal view. And in addition, such an expression happens to be in accordance with the idea of protection of taxpayers' rights, and thus helps it to spread widely. However, such an explanation seems more or less a speculation without concrete evidence to support it. As further proof of my stance, I refer to the case law in Europe. In most of the VAT regulations, whether EU Directives or the domestic VAT regulations of the Member States, there are such words bearing the meaning as the "right" to deduct, such as Article 19 of DPR 633/72³⁹⁹ in Italy, the term "il diritto alla detrazione" is repeatedly mentioned. Notwithstanding this fact, no case related to VAT deduction in the ECJ was (is) judged on the ground of protecting the taxpayers' right—right to deduct, but on basis of the principle of neutrality in order to relieve the trader entirely of the burden of VAT payable or paid in the course of all his economic activities, and the deduction system in VAT is just a method to achieve that purpose.

³⁹⁸ Vice professor Weng Wuyao in China University of Political Science and Law is one of them, and in one of his articles titled "On the generation of VAT deduction right" ("论增值税抵扣权的产生"), he suggested to establish the concept of right regarding the input VAT deduction. For further information, please refer to 翁武耀, "论增值税抵扣权的产生", 税务研究 (taxation research, ISSN:1003-448X), issue 12, 2014, p. 55-58.

³⁹⁹ ISTITUZIONE E DISCIPLINA DELL'IMPOSTA SUL VALORE AGGIUNTO (Decreto del Presidente della Repubblica 26 ottobre 1972 n. 633 e successive modificazioni ed integrazioni).

The following extracts from a judgments on VAT deduction serves as corroboration to my opinion: “the Court has stated repeatedly that the deduction system is meant to relieve the trader entirely of the burden of the VAT payable or paid in the course of all his economic activities. The common system of value added tax consequently ensures that all economic activities, whatever their purpose or results, provided that they are themselves subject to VAT, are taxed in a wholly neutral way...”⁴⁰⁰. However, the denial of the nature of VAT deduction as a right does not mean it has no relation to the protection of taxpayers’ rights. In fact, its effect of relieving the trader entirely of the burden of VAT payable or paid in the course of all his economic activities is the way it protects the taxpayers’ rights by saving their economic interests.

To make a conclusion, in general, I am not in favor of the proposition to strengthen the nature of VAT deduction as a right enjoyed by the taxpayers. However, the operation of such a system does have the objective effect of protecting taxpayers’ economic interests. The most important matter is the right being protected behind it—the relief of extra economic burden on taxpayers resulting from the imposition of VAT, in other words, it is what the mechanism to protect is the essence of VAT—to tax in a wholly neutral way. Therefore, whether or not to change the way it is called does not really matter, in China, the official documents on a national level name such an arrangement as “VAT deduction” (in Chinese: 增值税抵扣) is quite appropriate, from my point of view, and what really matters is the realization of the principle of neutrality through the careful design of the VAT deduction mechanism.

3.1.2 The time point for its establishment

In the VAT deduction system, the first issue to be resolved is when the right of deduction arises. Compared with the European regulations’ explicit rules on this issue,⁴⁰¹ that the right of deduction arises at the same time when the deductible tax

⁴⁰⁰ See, Judgment of the Court (Second Chamber) of 15 January 1998, Case C-37/95, *Belgische Staat v Ghent Coal Terminal NV*, 1998 I-00001, paragraph 15, and see in particular Case 268/83 *Rompelman v. Minister van Financiën* [1985] ECR 655, paragraph 19, and Case 50/87 *Commission v. France* [1988] ECR 4797, paragraph 15.

⁴⁰¹ As previously stated, in Europe, on the Commission level, the time for the right of deduction to arise is ruled in Article 167 of the VAT Directive 2006, a right of deduction shall arise at the time the

becomes chargeable, the relevant Chinese regulations appear to be quite inadequate or actually almost absent. No provision can be found in the two main Chinese VAT regulations⁴⁰² on the time when the input VAT can be deducted. And the only clue that could be found is the “Notice of State Administration of Taxation on Some Issues Relevant to the Adjustment of the Time Limit for Tax Credits Based on Value Added Tax Credit Vouchers”,⁴⁰³ which provides as follows:

A general taxpayer of value added tax who obtains special value added tax invoices, uniform invoices for road and freshwater freightage industry and uniform invoices for the sale of motor vehicles issued after January 1, 2010⁴⁰⁴ shall go through the certification formalities in the taxation organ within 180 days as of the date of issuance, and shall, within the tax filing period of the following month after the pass of the certification, file a tax return to the competent taxation organ for crediting against the input tax amount.⁴⁰⁵

No clear statement is provided regarding with the actual time for the VAT deduction, but just restricts the time period for the certification of invoices, otherwise no deduction is permitted. Some Chinese scholars⁴⁰⁶ have attributed this to the blank of the right nature of VAT deduction in China. As an opponent of the proposition to strengthen the nature of VAT deduction as a right, I certainly cannot agree with that viewpoint. In fact, this is just the result of different procedural arrangements. In China, the formal requirement (possession of the qualified VAT voice) for VAT deduction is given a separate procedural arrangement—“the certification formalities”, which in Europe is included in the process of claiming input VAT deduction. Which means, in China, the mere possession of a VAT invoice issued by the trader cannot be a qualified

deductible tax becomes chargeable.

⁴⁰² “Interim Regulation of the People's Republic of China on Value Added Tax” (2008 Revision), and “Detailed Rules for the Implementation of the Interim Regulation of the People's Republic of China on Value Added Tax” (2011 Revision).

⁴⁰³ Letter No. 617 [2009] of the State Administration of Taxation, being issued on 11-09-2009 as a Departmental Regulatory Document.

⁴⁰⁴ Since 2003, the State Administration of Taxation has successively taken such administrative measure as the 90-day time limit for filing and crediting taxes based on the special value added tax invoices and other tax credit vouchers. The 90 days was modified because, some taxpayers and taxation organs reported that the 90-day time limit for filing and crediting taxes is so short that some taxpayers are unable to credit against the input tax amount because of the late filing.

⁴⁰⁵ The same requirements apply to the general taxpayer of value added tax who is subject to the administrative measure—“tax credits after comparisons”—for the customs special bills of payment for value added tax on imported goods.

⁴⁰⁶ Weng Wuyao, “On the generation of VAT deduction right”, see above 397.

formal element, but a VAT invoice which has been certified by the authorities. On basis of this fact, input VAT becomes qualified for deduction when the relevant invoice is certified, and naturally, it is impossible to regulate the exact time for VAT deduction in China.

Compared with Europe, the current Chinese arrangement has its advantages in combating tax evasion or tax fraud in VAT. However, to return to the topic discussed previously—the balance between the interests of the state and of taxpayers. Obviously, such an arrangement is completely beneficial for the former. And with the background of present-day China, such a balance needs to be adjusted, which is also the demand of the taxpayers' right protection.⁴⁰⁷ And this is where we can make reference to the European VAT model, first, to move away the pre-procedure called “the certification formalities” for the application for VAT deduction. Second, to completely rebuild the VAT deduction mechanism in VAT legislation. And this is going to be a long story to tell. Every detail shall be weighed on the balance of interests (of the state and taxpayers). One thing of which I am quite sure is that the absence of the provision about the starting point of VAT deduction should be addressed.

3.1.3 Emphasis of the substantial requirements of its establishment

The requirements for the establishment of the right to deduct (in China, it is called VAT deduction) is another issue that is not in the same line between China and Europe. The difference is more exaggerated in the substantial aspects. In China, the substantial requirements are inferred from the negative provisions in which the non-deductible input VAT in certain circumstances is listed, but with no positive statements. The negative items are listed in Article 10 of Interim Regulation of the People's Republic of China on Value Added Tax:

The input tax amount on any of the following items shall not be offset against or be

⁴⁰⁷ In China, the tax law scholars hold the viewpoint that, the whole tax system in China, especially the procedural aspect is guided by the administrative thought patterns, in other words, the authority is at the dominant position and all the mechanisms are designed for its convenience, but not for the opposite side—taxpayers. Basically, I am agree with this point. And in current China, both the legislators and the academics are trying to change such a model through the reconstruction of the tax system by a series of tax reforms.

deducted from the output tax amount:

1. the purchased goods or taxable services used for non-VAT taxable items, VAT-free items, collective welfare or individual consumption;
2. the abnormally lost purchased goods and relevant taxable services;
3. the abnormally lost purchased goods or taxable services for products under production or finished products;
4. the taxpayer's self-use consumables as prescribed by the finance and taxation administrative departments of the State Council; and
5. the freight of goods and freight of sold tax-free goods as described in Items 1 through 4 of this Article.

The basic principle inferred from the above items is that the input VAT becomes deductible on condition that the goods or services it is charged on shall be used on VAT taxable items, but not personal consumption or any other non-VAT taxable items. However, without a general provision to explicitly rule out its positive substantial requirement, such a list just makes the situation much more complex and will lead both tax authorities and taxpayer into confusion. Therefore, I strongly recommend to add a positive provision to express the substantial requirement straightforwardly, just like Article 168 of the VAT Directive 2006:

In so far as the goods and services are used for the purposes of the taxed transactions of a taxable person, the taxable person shall be entitled, in the Member State in which he carries out these transactions, to deduct the following from the VAT which he is liable to pay...

In addition, the emphasis of the substantial requirements is put forward with respect to the excessive attention given to the formal requirement—the special VAT invoice. The formal one was chosen as a crucial element since it is the one can be liable used by the taxpayer to conduct illegal actions and it is also a relatively easy and direct aspect for the tax authorities to control. This might also be a reason for the existence of “the certification formalities”. However, in order to construct a modern VAT system, such a “barbarous” method is apparently not appropriate any more. And the adjustment or change can start with the newly added positive provision of the substantial

requirement, and then rearrange the order of the relevant provisions⁴⁰⁸.

3.2 To Extend the VAT Deductible scope

Based on the requirements described above, though not explicit, the principle of relevance between the goods or services bearing the input VAT with VAT taxable transactions is still demanded. However, such a general principle comes across problems in practice, especially in some special situations. Some might have been noticed in China and reflected in its regulations, some, however, might have not been realized yet, and thus still remain as a blank to be filled. In this section, two special situations are discussed based on the European experience and the Chinese current stipulations.

3.2.1 Deductible items

As the formal requirements occupy the dominant position for VAT deduction in China, the deductible items are regulated in Article 8 of the Interim Regulation⁴⁰⁹, including the following items:

1. The VAT amount indicated in the special VAT invoice;
2. The VAT amount indicated in the special bill of payment of import VAT;

⁴⁰⁸ In current VAT regulation—“Interim Regulation of the People's Republic of China on Value Added Tax (2008 Revision)”, the formal requirements (in articles 8 and 9) are ruled ahead of the substantial requirements (in article 10). And the latter performs like a supplement to the former by providing certain restrictions.

⁴⁰⁹ The original expression of Article 8 is: “The VAT amount that a taxpayer pays or bears for buying goods or accepting taxable service is the input tax amount.

The following input tax amounts are allowed to be offset against or be deducted from the input tax amounts:

- (1) the VAT amount as indicated in the special VAT invoice obtained from the seller;
- (2) the VAT amount as indicated in the special bill of payment of import VAT obtained from the customs house;
- (3) for the purchase of agricultural products, besides obtaining the special VAT invoice or customs special bill of payment of import VAT, the input tax amount is calculated on the basis of the agricultural product purchase price as indicated in the agricultural product purchase invoice or sales invoice and at a deduction rate of 13%. The formula for the calculation of the input tax amount:
the input tax amounts = the purchase price × the deduction rate
- (4) For the purchase or sale of goods and payments for freight during the production and business operations, the input tax amount is calculated on the basis of the freight amount as indicated in **the** freight settlement voucher and at the deduction rate of 7%. The formula for the calculation of the input tax:
the input tax amount = the freight amount × the deduction rate

Any adjustments to the allowed deduction items and rates shall be decided by the State Council.”

3. For purchase of agricultural products, 13%⁴¹⁰ of the purchase price indicated in the purchase invoice or sales invoice;

4. 7% of the freight payments⁴¹¹ indicated in the freight settlement voucher on condition such freights occur for the purchase/sale of goods or during the production and business operations.

In Article 10 some non-deductible items are listed from an angle of substantial requirements. This reflects the principle of relevance. The disadvantages of such arrangements were mentioned in the previous section. But if viewed merely from the actual effect, such a combination is more or less the same as the relevant rules stipulated in the EU VAT Directive 2006. However, along with the deepening of VAT reform, the industries previously liable to BT have been included into the scope of VAT, such as transportation, thus, the deductible item 4 shall be accordingly modified in the subsequent legislation.

3.2.2 Deduction for enterprises carrying out mixed businesses—proportionate deduction

Compared with the rather mature and comprehensive experience of the EU of the deduction for enterprises carrying out mixed businesses, China's VAT system has a long way to go in this aspect.

In order to address this question better, the subject of enterprises carrying out mixed businesses shall be clarified first. Prior to this, the terms of VAT taxable activities and non-VAT taxable activities shall be distinguished. For the former, a profound introduction has been made in the previous Chapter 2. The emphasis here is to be put on the latter one—non-VAT taxable activities. To be understood broadly, it refers to both the activities excluded from VAT for their nature and the activities excluded for some external considerations (such as policy) otherwise they are VAT taxable⁴¹².

⁴¹⁰ The VAT rate for agricultural products is 13%, and not make the special VAT invoice as a compulsory demand is out of the supporting for the agricultural industry development.

⁴¹¹ The reason for such a deduction is, the transportation is taxed by BT at the rate of 7% prior to VAT reform.

⁴¹² For this part, including VAT-free (exemption) and VAT reduction items. Such as items listed in

Accordingly, the enterprises in question can be divided into three groups: first, enterprises carrying out both VAT taxable activities and non-VAT taxable activities based on their nature; second, enterprises carrying out VAT-free or VAT reduction activities in addition to the normal VAT taxable activities; third, enterprises integrating the above two kinds. Due to the special tax system in China—the co existence of VAT and BT, part of the non-VAT taxable activities are VAT taxable in Europe. And since there is no explicit definition of “economic activities”—an essential element to be VAT taxable in Europe—in China, the activities that are completely non-VAT taxable based on their nature are not taken into consideration, and no relevant VAT deduction method comes into being either. More detailed descriptions are given below.

With regard to the VAT deduction system in respect of enterprises carrying out mixed businesses, the EU has a sophisticated system called “proportional deduction”, while in China, the relative mechanism works in the following way:

First, there are no relevant regulations about VAT deduction on the mixed business, but only about how to charge VAT in such situations.

Second, the “one or the other way” treatment of a sale involving both goods and non-VAT taxable services. Such a mixed sale is either viewed as a sale of goods subject to VAT as a whole or regarded as a sale of non-VAT services not subject to VAT⁴¹³. There are exceptions, however: selling self-produced goods while providing services in the construction industry and other circumstances as prescribed by the Ministry of Finance and the State Administration of Taxation⁴¹⁴.

Third, for a VAT taxpayer who concurrently engaged in any non-VAT taxable item, separate accounting is required with regard to the sales amounts of goods or taxable

Article 15 of Interim regulation of VAT in China and the exemption items listed in TITLE IX Exemptions of VAT Directive 2006.

⁴¹³ See Article 5 of “Detailed Rules of the Implementation of the Interim Regulation of the People’s Republic of China on Value Added Tax (2011 Revision)”. Prior to the VAT reform, in general, sales of goods are subjected to VAT, and providing or services is subjected to Business Tax.

⁴¹⁴ See Article 6 of “Detailed Rules of the Implementation of the Interim Regulation of the People’s Republic of China on Value Added Tax (2011 Revision)”.

services and the turnover of non-VAT taxable items⁴¹⁵.

Last, for a taxpayer concurrently engaged in VAT-free or VAT reduction items, separate accounting is required as well, otherwise it (he) shall not enjoy the tax exemptions or reductions⁴¹⁶.

Through the above rules on the mixed businesses, a basic conclusion is that the mode of Chinese VAT deduction in such a situation is rather extensive, only different ways of imposition of output VAT have been considered but not the deduction of input VAT. And this is the deficiency which needs to be made up in the future reform and the relevant law legislation.

The importance of emphasis on the protection of taxpayers' rights was discussed in above, but the absence of the proportional deduction of the mixed businesses is an infringement to the interest of the treasury—a percentage of input VAT which is not supposed to be deductible is deducted. Hence, the adoption of the proportional deduction method, to some extent, is a compensation to the potential loss of the state's fiscal interest due to the emphasis of taxpayers' interests in other aspects. The separate accounting applied in the VAT charging process provides a solid foundation for its adoption. Of course, more profound analyses still need to be done in its detailed establishment according to the special conditions in China, but I am not going to penetrate deeply into this subject.

3.3 The exercise of VAT deduction

Having discussed the theoretical issues of VAT deduction in China, the practical problems come in their turn. Their exercise should be subject to the test of the principle of neutrality and protection of taxpayers' rights. The following two issues remain to be settled: restrictions to VAT deduction and the subsequent treatment of the excess deductible input VAT.

⁴¹⁵ It is prescribed in Article 7 of “Detailed Rules of the Implementation of the Interim Regulation of the People’s Republic of China on Value Added Tax (2011 Revision)”, the non-VAT taxable item not includes the non-VAT taxable services which are subjected to Business Tax.

⁴¹⁶ It is regulated in Article 16 of the Interim Regulation of VAT.

3.3.1 Restrictions to VAT deduction

An ideal and completely neutral VAT system must contain an integral and thorough deduction mechanism with no restrictions. However, the situation in a real world is much more complicated. And no pure VAT deduction system has ever existed in the world, considering the substantial equality, the compliance and administration costs, etc., each VAT system has its own restrictions to such a deduction chain and at the same time imposes restrictions to the inevitable extent according to the newly emerging situations and circumstances. And China is no doubt experiencing such a moment.

Based on the analysis of current regulations on the restrictions to VAT deduction in China, here are some conclusions about the aspects to be improved, in my personal opinion.

First, on the whole level, the regulations regarding restrictions on VAT deduction are not well organized. In the Interim Regulation of VAT, except the non-deductible result for not fulfilling the requirements to be deductible, either formal one or substantial ones,⁴¹⁷ there is only one article that explicitly provides that input VAT of small-scale taxpayers shall not be offset or deducted⁴¹⁸. With regard to the tax-free provisions, its non-deductible nature is expressed in an indirect way by ruling that no special VAT invoice shall be issued under such a circumstance⁴¹⁹. The “disorder” results from the absence of a separate section on VAT deduction, which not does quite match with its position in the whole VAT system.

Second, to start from the detailed non-deductible items, those given above are regulated by the relatively formal and authoritative document, but out of the Interim Regulation of VAT, there still exist restrictions in practice, most of which are

⁴¹⁷ Being ruled separately in Article 9 and Article 10 of the Interim Regulation of VAT.

⁴¹⁸ It is stipulated in Article 11: For selling goods or taxable service of a small-scale taxpayer, a simple approach shall be employed to calculate the payable tax amount on the basis of the sales amount and at the tax rate and the input tax amount shall not be offset or deducted...

⁴¹⁹ In Article 21 of the Interim Regulation of VAT, it lists certain circumstances under which the special VAT invoice shall not be issued: (1) the goods or taxable services are sold to individual consumers; (2) the tax-free provisions apply to the goods or taxable services sold; and (3) the goods or taxable services are sold by small-scale taxpayers.

regulated in the form of Announcements or Notices of the tax administration, such as the non-deduction of input VAT by falsely issued special VAT invoice. Therefore, it is urgent to legislate so that the restrictions to VAT deduction can be well organized both from the structure and content aspects.

Last, based on the above two points, both from the structure and content aspects, and combined with the lesson learned from the EU, my specific suggestions are to regulate VAT deduction with a separate chapter in the future VAT law, in which the restrictions of VAT deduction shall be ruled in one section, under the governance of a general principle—“VAT shall in no circumstances be deductible in respect of expenditure which is not strictly business expenditure”⁴²⁰. Detailed restrictions shall be distributed according to various standards, such as non-deductibility of special arrangements from the origin—exemption, small-scale taxpayer or tax-free, etc; non-deductibility because of failure to fulfill the basic requirements (either formal ones or substantial ones); and non-deductibility based on special considerations.

In all, the restrictions shall be limited to the extent necessary, and such an extent shall be tested in practice, the standard is again the balance between the interests of the state and of taxpayers with the fulcrum of the neutrality principle.

3.3.2 Treatment of the excess deductible input VAT

This issue has been deliberated in the previous chapter (Chapter 4), the prominent problem in China is the lack of an immediate refund mechanism of the excess deductible input VAT. The only choice for a taxpayer is to carry it forward to the following period for offset or deduction⁴²¹. On the other hand, the immediate refund of the excess deductible input VAT in Europe is facing its own trouble: the widespread tax evasion and tax fraud aiming to take advantage of the refund mechanism. And the refund procedure demands extra workload and costs for both the tax authority and

⁴²⁰ This is drawn from Article 176 of the VAT Directive 2006.

⁴²¹ See Article 4 of the Interim Regulation of VAT in China (2008 version): “... If the output tax amount for the current period is less than and insufficient to offset against or deduct the input tax amount for the current period, the deficiency can be carried forward to the following period for offset or deduction.”

taxpayers. Therefore, I recommend, before starting the refund procedure, to enlarge the scope of offset tax debt, not restricted to output VAT, but spread to the other types of tax debt that the taxpayer owes to the tax authority, of course, the output VAT shall be offset in the first place. And the annual refund shall be permitted under certain situations—as an alternative for taxpayer other than to carry it forward to the next year. Such as the related regulations in Italy—in Article 30 of the DPR 633/72, the taxpayer in general is entitled to carry forward the excess amount to the next year's deduction or, under certain conditions, can seek reimbursement if: (1) the excess amount is over 5 million lire; (2) it fulfills one of the situations in which the amount of future output VAT of taxpayer is too small to be deducted;⁴²² (3) the taxpayer may request a refund of the deductible excess not confined by the restriction at point (2) if the two previous years' annual tax statements are deductible tax surpluses⁴²³.

The Italian method can serve as a beneficial reference to our future reform to the treatment of the excess amount of deductible input VAT, this method, however, requires powerful support from mechanisms such as the tax information system, the adjustment of the declaration period, and the other conditions settings to avoid such a mechanism might be easily used by unlawful taxpayer. The supporting construction of the related procedural legislation to promote all the mentioned suggestions in the previous contents will be discussed in the following section, as preliminary to a

⁴²² See Paragraph 3 of Article 30 in DPR 633/72 (Istituzione e Disciplina dell' Imposta sul Valore Aggiunto):

3. Il contribuente può chiedere in tutto o in parte il rimborso dell'eccedenza detraibile, se di importo superiore a lire cinque milioni, all'atto della presentazione della dichiarazione:
- a) quando esercita esclusivamente o prevalentemente attività che comportano l'effettuazione di operazioni soggette ad imposta con aliquote inferiori a quelle dell'imposta relativa agli acquisti e alle importazioni, computando a tal fine anche le operazioni effettuate a norma dell'articolo 17, quinto comma;
 - b) quando effettua operazioni non imponibili di cui agli articoli 8, 8-bis e 9 per un ammontare superiore al 25 per cento dell'ammontare complessivo di tutte le operazioni effettuate;
 - c) limitatamente all'imposta relativa all'acquisto o all'importazione di beni ammortizzabili, nonché di beni e servizi per studi e ricerche;
 - d) quando effettua prevalentemente operazioni non soggette all'imposta per effetto dell'articolo 7;
 - e) quando si trova nelle condizioni previste dal secondo comma dell'articolo 17.

⁴²³ See Paragraph 4 of Article 30 in DPR 633/72 (Istituzione e Disciplina dell' Imposta sul Valore Aggiunto):

Il contribuente anche fuori dei casi previsti nel precedente terzo comma può chiedere il rimborso dell'eccedenza detraibile, risultante dalla dichiarazione annuale, se dalle dichiarazioni dei due anni precedenti risultano eccedenze detraibili; in tal caso il rimborso può essere richiesto per un ammontare comunque non superiore al minore degli importi delle predette eccedenze.

deeper analysis of this matter.

4. Supporting construction of the related procedural legislation

All the suggestions or criticisms above are from the angle of substantive law, however, to put them into implementation needs the supporting procedural law⁴²⁴. The Chinese tax system is going through a revolutionary moment, and the ongoing VAT reform is only a small part therein. The recent revision of the “Law of the People’s Republic of China on the Administration of Tax Collection”⁴²⁵ has aroused a heated discussion on several issues, especially about the addition of the chapter on “tax liability” and rules on tax information disclosure. In this section, I am going to give two points to be adjusted according to the future VAT system building.

4.1 Annual declaration and adjustment system for VAT

The VAT taxable period in China is regulated in Article 23 of the Interim Regulation on VAT with regard to the domestic transactions and Article 24 with regard to importation. For the former situation, the periods can be one day, three days, five days, 10 days, 15days, one month or one quarter. “The specific taxable period of a taxpayer shall be determined respectively by the competent taxation organ on the basis of the payable tax amount of the taxpayer.” “If the tax cannot be paid on a regular period basis, it can be assessed on a transaction-by-transaction basis.” And with the latter situation, “a taxpayer of imported goods shall pay the tax within 15 days from the date on which the customs house fills out the special bill of payment of import VAT issued by the customs offices.” Compared with the similar mechanism in Europe, Chinese VAT does not have an annual declaration and adjustment of VAT due and any deductions. Such a procedural arrangement is suitable to the substantive design of

⁴²⁴ The substantive law and procedural law here do not only refer to the overall nature of a specific regulation, such as Interim Regulation on VAT as a substantive law and the tax administration act as a procedural law; but also classify the different nature of the detailed provisions in one same regulation, for example, in the Interim Regulation on VAT there are both the substantive provisions on tax base, tax rate and so on, and the procedural provisions on tax period, tax return, etc.

⁴²⁵ Adopted at the 27th Session of the Standing Committee of the Seventh National People's Congress on September 4, 1992, the Law has gone through four times of modifications, respectively in 1995, 2001, 2013 and 2015.

VAT prior to the reform—with no proportional deduction⁴²⁶ and no permission of the refund of the excess deductible input VAT, however, along with the perfection of the substantive aspects in the future, the introduction of the annual declaration and adjustment mechanism in VAT is no doubt required and needed.

4.2 Protection of taxpayers' rights in the procedural tax law

Prior to the final issue of the 2015 version of the Law of the People's Republic of China on the Administration of Tax Collection on April 24, the Legislative Affairs Office of the State Council released the Revised Draft of the Tax Administration Law (Discussion Draft) to collect public comments and opinions. In the Discussion Draft, one of the most important breakthroughs is to further improve the taxpayer protection system, including the perfection of the taxpayers' rights system,⁴²⁷ to reduce the burden on taxpayers,⁴²⁸ to cancel tax due for payment prior to application for the administrative consideration of a decision, and to introduce advance ruling of tax due system.⁴²⁹ Though most of the modifications were not adopted in the official version of the final revised Tax Administration Law, such changes do give a good signal and give rise to a heated discussion in the public.

When it turns to the VAT system, because of the special mechanism of VAT deduction, besides the general provisions on protection of taxpayers' rights ruled in the tax administration law, more specific procedural supporting provisions shall be regulated in the future VAT law. First, the process of the exercise of VAT deduction shall be reorganized and integrally ruled in the law, in order to better protect the reliance interest of taxpayers and to reduce compliance costs. Especially the rules on the management of the special VAT invoice, the pre-control process of the invoice—"the certification formalities"—is questionable, and in my opinion, there is a need either to

⁴²⁶ In Europe, with regarding to the proportional deduction, the proportion calculated monthly might be quite different due to the operating conditions of each month, the annual adjustment makes the deductible input VAT more suitable and equitable for both the Treasury and the taxpayer.

⁴²⁷ However, the final vision being issued has not adopted, and still remain the same statements in Article 8.

⁴²⁸ Including to interrupt the interest calculation for late payment under certain situations and to lighten punishment standard on the whole.

⁴²⁹ The advance ruling system is applicable when the taxpayer cannot or difficult to directly apply the tax regime to its future complex transactions or other taxable activities to determine its tax due.

embrace it into the VAT deduction decision process or at least to extend the period⁴³⁰. Second, with regard to the treatment of the excess amount of the deductible input VAT, to better protect the taxpayers' interest, introduce the immediate refund mechanism under certain conditions. The existing treatment which can only carry it forward to the following tax periods is totally designed for the interest of the treasury and the convenience of the tax administration, but with no consideration of the interest of taxpayers. The non-deductibility results artificially from the pure mechanism also does not meet the principle of neutrality—to relieve the taxpayer totally from the extra tax burden.

In the end, the Chinese tax system is entering an era of rebuilding, and the ongoing VAT reform is just a small part of the whole “revolution”, however, as a neutral indirect tax and with its pivotal role in the state's revenue generation, its importance and significance go without saying. Notwithstanding the difficulties encountered during the reform from the outside, such as the financial pressure and tough industries; and the complexity of the system design per se, in particular of VAT deduction therein, the reform is expected to be completed in 2016 by embracing the three most problematic industries into the scope of VAT, then the legislation of a formal VAT law is the next step to be taken. At the point of this special moment, the study of China's VAT system from a historical perspective and the research of international experience from a comparative prospect are both significant for the future perfection of China's VAT system and its legislation. And through the study of both sides, I personally hold the view that attention and efforts should be directed to both abstract and concrete aspects. For the former, the choice of guiding principle and the protection orientation of the interested party are the primary issues to be decided. By combining China's special historical background and the real situation of China's VAT with the European experience and its own problems, I recommend to review the principle of neutrality in VAT, to hold it as the guiding principle for the reform; and to stress the protection of taxpayers' rights, to put more weight on the taxpayers' interest side on its balance with

⁴³⁰ The period was primarily set as 90 days in 2003, and being extended to 180 days in 2010, see above 10.

the interest of the state. When it comes to the latter, the concrete aspect of the construction of the VAT system, the core mechanism therein—VAT deduction—is the central point. Discussion is made from the nature of VAT deduction, its establishment and its exercise. In my view, though in Europe VAT deduction is called the right of deduction or the right to deduct, it does not necessarily mean that it is a substantial right enjoyed by the taxpayer, the essence or crucial spirit of this mechanism is to ensure the neutrality of VAT through relieving the taxpayer from extra tax burden, as the character of VAT is an indirect tax imposed on the final customers. Therefore, I am not in favor of defining VAT deduction as a right of the taxpayer and to establish it by the law. But I strongly recommend to fix the VAT deduction mechanism in a separate chapter or section in China's future VAT law, which is beneficial for the other two issues related to it—its establishment and its exercise. With regard to the establishment of VAT deduction, more explicit and clear expression of the substantial requirements shall be given and the fact of over-reliance to the formal element—the VAT invoice—shall be changed. In other words, VAT deduction must not be easily negated by flaws of the invoice, such as being falsely issued. This is not an issue of its establishment, but also a matter in its exercise, besides this, the deductible items and restrictions to VAT deduction shall be redefined as well. Under the guidance of the principle of neutrality, in general, the deductible items shall be extended⁴³¹ and the restrictions shall be limited and reorganized. And at the end of its implementation, the treatment of the excess amount of the deductible input VAT needs to be enriched by introducing the direct refund approach and the offset to other tax debt.

All the substantive parts to be improved above rely on synchronous development of the procedural aspects. Among these, I think the most important are, first, to establish the annual declaration and adjustment mechanism in VAT and, second, to provide procedural protection to the interests of taxpayers.

⁴³¹ China's VAT has gone through a transition reform from a productive type VAT to a consumption reform, while, it is not thorough enough, as most of the capital investments still cannot be deducted. And the extension here not simply by enlarge the list of deductible items, but to extend the scope by setting up a general standard. And for this aspect, the European method can provide some inspiration—the relevance principle. That is, the goods or services on which input VAT is imposed shall be used into taxable transactions.

Annex 1

Decision of the National People's Congress on Authorizing the State Council to Formulate Interim Provisions or Regulations Concerning the Reform of the Economic Structure and the Open Policy (Effective)

DECISION OF THE THIRD SESSION OF THE SIXTH NATIONAL PEOPLE'S

**CONGRESS ON AUTHORIZING THE STATE COUNCIL TO FORMULATE
INTERIM PROVISIONS OR REGULATIONS CONCERNING THE REFORM OF
THE ECONOMIC STRUCTURE AND THE OPEN POLICY**

(Adopted at the Third Session of the Sixth National People's Congress on April 10, 1985)

With a view to ensuring the smooth progress of the reform of the economic structure and the implementation of the open policy, the Third Session of the Sixth National People's Congress decides to authorize the State Council to formulate, promulgate and implement, whenever necessary, interim provisions or regulations concerning the reform of the economic structure and the open policy in accordance with the Constitution without contravening the relevant laws and the basic principles of the relevant decisions of the National People's Congress and its Standing Committee, and to report them to the Standing Committee of the National People's Congress for the record. These provisions and regulations shall be made into law by the National People's Congress or its Standing Committee after they are tested in practice and when conditions are ripe.

Annex 2

Decision of the Standing Committee of National People's Congress Authorizing the State Council to Reform the System of Industrial and Commercial Taxes and Issue Relevant Draft Tax Regulations for Trial Application [Expired]

Decision of the Standing Committee of NPC Authorizing the State Council to Reform the System of Industrial and Commercial Taxes and Issue Relevant Draft Tax Regulations for Trial Application

(Issued by the Standing Committee of the National People's Congress on September 18, 1984)

The Seventh Meeting of the Standing Committee of the Sixth National People's Congress, having considered the proposal of the State Council, decides to authorize it to draft regulations relating to taxation and issue them in the form of drafts for trial application while introducing the practice according to which state enterprises pay taxes instead of turning over their profit to the state, and in the course of reforming

the system of industrial and commercial taxes. The draft regulations shall be revised in the light of the experience gained through trial application and shall be submitted to the Standing Committee of the National People's Congress for examination. These draft regulations on taxation to be issued by the State Council for trial application shall not apply to Chinese-foreign equity joint ventures and enterprises with foreign capital.

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